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CAPITAL MANAGEMENT

THE WARRING TWENTIES

Farewell to an unconventional decade; dawn of a tempestuous era

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Equities closed out the final month of the decade with solid returns as the cyclical recovery thesis gained more credence following the Tory's huge electoral victory in the U.K. and a tentative phase-one trade deal between the U.S. and China. Despite divisive impeachment proceedings, Congress played Santa by passing a huge bipartisan $1.4 trillion omnibus appropriations bill to make spending (and deficit) great again and President Trump was more than happy to oblige. The Fed got into the holiday spirit even earlier, having banished the Grinch known as Quantitative Tightening in August, and then continuously injected more than $400 billion into the financial system to stabilize the repo market. These measures have re-steepened the yield curve and transformed the market's recession fear at the start of 2019 into bubbly complacency by year end. As a result, the S&P 500 Index turned in the second-best year of the decade and practically every asset class had positive returns in 2019. The tenor of the year's equity rally was also a fitting reflection on the decade – the Fed's rate cuts and balance sheet expansion trumped lackluster growth. In perfect hindsight, "Don't Fight the Fed" was the mantra of the 2010s.

The decade ended with two notable losses. On December 8th, former Fed Chairman Paul Volcker, a financial giant – figuratively and literally with his 6'7" height – passed away at age 92. The death of this inflation and deficit hawk who believed in sound money and good government was symbolic of the seismic shift in Washington – the Fed is now trying to rekindle inflation, and deficit hawks appear to have become extinct. Two days after Volcker's passing, the World Trade Organization's (WTO) dispute settlement panel, the Appellate Body, lost its adjudicating authority after two of its remaining three judges' terms expired. The Trump Administration has systematically blocked the naming of new judges to the seven-member panel, and the WTO requires at least three judges to adjudicate each case. The crippling of the WTO's trade dispute resolution power may start to unravel the global trade framework built up over the past five decades and usher in an era of unilateralism and rising trade barriers. In short, there are no more policy sacred cows as we enter the second decade of the era of New Normal.

EQUITY MARKET INDICES[1]	11/29/19	12/31/19	MTD	YTD
MSCI All Country World	547	565	3.4%	24.0%
S&P 500	3141	3231	2.9%	28.9%
MSCI EAFE	1974	2037	3.2%	18.4%
Russell 2000	1625	1668	2.7%	23.7%
NASDAQ	8665	8973	3.5%	35.2%
TOPIX	1699	1721	1.3%	15.2%
KOSPI	2088	2198	5.3%	7.7%
Emerging Markets	1040	1115	7.2%	15.4%
Fixed Income				
2-Year US Treasuy Note	1.61%	1.57%	-4	-92
10-Year US Treasuy Note	1.78%	1.92%	14	-77
BarCap US Agg Corp Sprd	1.05%	0.93%	-12	-60
BarCap US Corp HY Sprd	3.70%	3.36%	-34	-190
USD Performance				
Chinese Renminbi (CNY/$)	7.03	6.96	-1.0%	1.2%
Brazil Real (Real/$)	4.24	4.03	-4.9%	3.8%
British Pound ($/GBP)	1.29	1.33	-2.5%	-3.8%
Euro ($/EUR)	1.10	1.12	-1.7%	2.3%
Japanese Yen (Yen/$)	109.49	108.61	-0.8%	-1.0%
Korean Won (KRW/$)	1181.45	1156.25	-2.1%	4.1%
US Dollar Index (DXY)	98.27	96.39	-1.9%	0.2%
Commodities				
Gold	1464	1517	3.6%	18.3%
Oil	55.2	61.1	10.7%	34.5%
Natural Gas, Henry Hub	2.28	2.19	-4.0%	-25.5%
Copper (cents/lb)	264	280	5.9%	6.3%
CRB Index	177	186	5.2%	9.4%
Baltic Dry Index	1528	1090	-28.7%	-14.2%

Source: Bloomberg.

The single most important question for the new decade is whether the prolonged and expanded use of ultra-loose monetary policy tools designed for an emergency will finally incur grave side-effects like escalating inflation and a loss of central bank credibility.

THE ROARING TWENTIES

"*New Year's Eve Gay in Hotels, Quiet on Streets*" was the headline on the January 1st, 1920 edition of The New York Times. It captured the mood of the New Year's Eve revelers a century ago, as they sought to enjoy a few more glasses of "intoxicating liquors" at local drinking establishments before the Volstead Act went into effect on January 17th. The Volstead Act, or the National Prohibition Act, was designed to carry out the intent of the 18th Amendment, which banned the manufacturing, sale, or transportation of intoxicating liquors. It was the culmination of the Temperance Movement that started in the early 1800s, and its supporters believed that it would lead to increased piety and reduced crime and spousal abuse in America. However, this "noble experiment" ignored the fact that many Americans were not about to give up drinking just because the government chose to legislate morality. In fact, it led to a period of social and cultural upheaval and a golden era for organized crime.

From coast to coast, crime syndicates ran complex bootlegging operations to smuggle alcoholic beverages. Booze runners souped up automobiles with modified engines to outrun police vehicles while transporting alcohol to illegal bars and clubs called speakeasies. The most celebrated crime boss of the day, Al Capone, reportedly raked in more than $100 million a year and controlled 10,000 speakeasies in Chicago. As speakeasies started popping up like mushrooms in cities, they competed by integrating dancing and live jazz bands to spice things up. Young women in flapper dresses – hemlines above the knees and low necklines – flocked to these illicit establishments to drink, smoke and dance. This new wave of counterculture caught on quickly and ushered in the Jazz Age that propelled the careers of Louis Armstrong, Fats Waller, Duke Ellington, Bix Beiderbecke and many others.

The decadence and the razzle-dazzle of the era earned the moniker "the Roaring Twenties" and inspired books such as The Great Gatsby and Gentlemen Prefer Blondes. In 1927, Hollywood released its first feature-length sound film The Jazz Singer, which effectively ended the silent film era. Tinseltown also produced classic gangster films The Public Enemy, Little Caesar, and Scarface; the last of the trio was remade in 1983 starring Al Pacino, with the storyline changed from booze to drugs.

The Roaring Twenties ended with a thud after the bursting of the stock market bubble triggered an economic downturn that metastasized into the Great Depression. Partially driven by the need for new tax revenues to finance the New Deal, the 21st Amendment was ratified at 5:32 pm on December 5th, 1933 to repeal to the 18th Amendment. President Franklin D. Roosevelt issued a proclamation that evening declaring the end of Prohibition.

While the country was still mired in the throes of the Great Depression in 1934, bartenders were suddenly in demand as restaurants and hotels scrambled to reopen bars and serve drinks. However, it was business as usual at the prestigious Yale Club of New York, which had the foresight and financial prowess to stock up enough alcohol so its patrons were never hung out to dry during the 14-year long Prohibition. Now that's the value of a first-rate education and should give Yalies some bragging rights over their crimson-colored rivals to the north.

THE NAMELESS TWENTY-TENS

The Roaring Twenties along with the Gay Nineties (1890s) and the Swinging Sixties (1960s) were periods named for their sociocultural transformation. A few other decades also earned catchy monikers for their distinctive characteristics – the 1970s were called the Me Decade, followed by the Greed Decade. Then there were those nameless decades like the 1900s and the 2000s. The one we just bid adieu to, the 2010s, will likely fall in that nameless category even though it was quite an eventful era for the financial market.

The 2010s has the distinction of being the only decade in U.S. history to avoid a recession. It had a lot to do with the depth and timing of the Great Recession, which "officially" ended in mid-2009, but led to a decade of extreme monetary policies – large-scale money printing (QE), zero-interest rate policy here, and negative interest rates in Europe and Japan. The big-four central banks – the Fed, the European Central Bank, the Bank of Japan, and the People's Bank of China – have more than doubled their combined balance sheets from $9.5 trillion to nearly $20 trillion over the past ten years. Money printing and low rates facilitated a decade of binge borrowing by the U.S. government, which piled up its debt from $12.3 trillion to over $23 trillion.

In spite of growth drivers such as ultra-low interest rates, trillions of dollars of newly minted money, massive government borrowing and spending, and the fortuitous timing of exiting from a deep recession at the start of the decade, the U.S. only managed to grow its real GDP at a 2.2% annual pace over these ten years. However, this subdued but relatively steady pace was enough to create an aura of U.S. exceptionalism as the rest of the world was dealing with challenges such as sovereign debt crises, collapsing commodity prices, and China's decelerating growth. As a result, the S&P 500 Index generated a world-beating 13.5% annual return over the last decade, way ahead of the next best major index, Nikkei-225's 8.6%.

BACK TO THE FUTURE

The S&P 500 Index's material outperformance during the 2010s was in part boosted by the meteoric rise of the so-called FAANG and various tech and fintech stocks. We see some parallels between the technology renaissance of the 2010s and the dot-com boom of the 1990s. U.S. leadership in innovation helped the S&P 500 Index generate a world-leading 18% annualized return during the 1990s. The four horsemen of the Internet and various dot-com sensations were lionized during the 1990s just like today's FAANG and so-called unicorns. Both periods saw record amounts of venture capital being poured into start-ups at soaring private market valuations. At the turn of the century, 3G was the emerging mobile technology to revolutionize the world just like today's nascent 5G. Both decades ended with the Fed injecting large amounts of cash into the financial system – Chairman Greenspan did it to inoculate against potential Y2K-induced hiccups; Chairman Powell has been injecting hundreds of billions of dollars to relieve the liquidity crunch in the repo market.

By the time the calendar turned to the Noughties (the 2000s decade), the economic expansion that started in early 1991 was about to enter its tenth year, and some pundits were espousing the view that the conventional business cycle had finally been tamed. That conjecture turned out to be wishful thinking. The subsequent implosion of the dot-com bubble and the Great Financial Crisis in the final years of the decade resulted in an annualized loss of 1% for the S&P 500 Index during the 2000s, the only decade of negative return since the 1930s.

To be clear, we are not implying that the 2020s will also be a decade of negative returns. The 2000s was unique in being bookended by the bubble implosion and the worst financial crisis in over seventy years. Currently, stock valuations, while higher than long-term averages, are not close to the 2000's bubble territory. That said, the new decade is starting at what may be the latter stage of the longest U.S. economic expansion. Corporate profit margins are around record highs, thanks in part to procyclical fiscal and monetary stimulus. It's hard to see the investment backdrop getting much better than this, and there will be a cyclical downturn ahead. This combination portends subdued investment returns for the new decade.

THE WARRING TWENTIES

Every decade has a unique set of investment drivers. The 2010s were buoyed by exceedingly easy monetary policies and the rise of the big tech companies. The Noughties had the commodity super-cycle thanks to a China-led emerging market growth streak. The 1990s enjoyed the dot-com boom while Europe was boosted by the impending monetary union. The 1980s was powered by the pro-growth Reagan-Thatcher revolution and Japan's epic bubble. What will be the major drivers for the 2020s? We suspect it will be an era in which big issues that have been fermenting for years – climate change, U.S.-China rivalry, inequality, etc. – finally come to a head.

If 2019's climate-induced disasters – Europe's record-breaking heat waves, Greenland's melting ice sheets, the Amazon rainforest wildfires, and the raging bushfires threatening practically every major city in Australia – are any guide to the future, there will be growing public support for a war on climate change. 2020s will likely be a decade of "Green Deals" with governments offering more incentives to accelerate the adoption of green buildings, electric vehicles, and renewable energy, while levying higher carbon taxes and surcharges on fossil fuel production and consumption.

On the geopolitical front, the trade war between the U.S. and China may just be a warm-up for the strategic rivalry that will put tech supremacy front and center. It remains to be seen if the West will maintain an adversarial stance in going after some of its most innovative companies, the Big Tech, while China pursues a state-subsidized industrial policy. The strategic rivalry will also force many countries to choose sides, thereby hurting global trade via protectionism and regionalism. These developments will impact regional investment outlook. While the U.S. market remains the darling of investors due to its dynamism and a largely pro-business administration today, our contrarian instinct suspects it's time to look for overseas opportunities. Looking back fifty years, each decade's best performers – Hong Kong in the 1970s, Japan in the 1980s, U.S. in the 1990s, emerging markets in the 2000s – have all failed to repeat that feat in the subsequent decade. At this point, we have high hopes for the U.K. as Prime Minister Boris Johnson just won a five-year mandate for his pro-growth agenda.

On socioeconomic issues, the new decade will likely experience more acute class warfare as the widening income and wealth inequality gets exacerbated by new technologies' disruption to traditional jobs, not to mention the baby boomer retirement wave and the pension underfunding issue. Political center in the West may further lose out to populist movements on both extremes of the political spectrum. Ironically, the common ground between the left and right-wing populism is greater government spending for social safety net and protectionism. As such, politicians will likely pursue activist fiscal policies at the expense of fiscal prudence. Modern Monetary Theory, which calls on central banks to directly underwrite massive public spending, may no longer be a fringe idea as governments look to the money printer to finance their profligacy. It may create a temporary sugar high for the economy with increased infrastructure spending and public transfer payment, but there will be a price to pay in the long run. In the final analysis, the single most important question for the new decade is whether the prolonged and expanded use of ultra-loose monetary policy tools designed for an emergency will finally incur grave side-effects like escalating inflation and a loss of central bank credibility. The experience from the last decade supports a sense of complacency, but the history of the prior few thousand years shows otherwise.

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