

The embarrassing legacy of financial capitalism: implications for investors

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Abstract

Regime shift: towards a rebalancing from financial capital to physical tangible capital

In the ongoing regime shift, investors have to deal with significant legacies stemming from the previous regime (the one initiated under former Fed Chair Paul Volcker), namely two forms of inflation: asset price inflation over the course of three decades and more recently inflation in the price of goods and services.

We argue that underinvestment in the old economy has fuelled (albeit with a lag) the current resurgence of good old inflation while overinvestment in some areas of the so-called 'new' economy (the internet bubble in 1999, the Tech hype between 2015 and 2021) has inflated some sectors financially.

We also argue that these sharp discrepancies resulted from a combination of high demanded returns in equity (which discouraged real investments in most sectors) and the low cost of capital (which catalysed various forms of hubris, bubbles and leverage).

While overinvested sectors in the 'new economy' may be a rising component of the future landscape, some of these 'tech dreams' are built on fragile foundations. The fate of the broad economy lies (and will continue to lie) in the so-called old economy, as people are beginning to realise the impact of scarcity regarding simple, immediate and vital things. **The most straightforward consequence is less growth and more inflation at trend: stagflation is the main risk embedded in the new regime, just like deflation characterised the previous one. These changes have profound consequences for investors.**

About the author



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I. A tale of two inflations

I.1. Alice in Wonderland: distortions due to an artificially low cost of capital

We argue that the (artificially) low cost of capital has provoked massive and interrelated distortions:

- i. Between present and future consumption of goods and services;
- ii. Between asset prices and the price of goods and services (i.e. relative prices);
- iii. Between financial investment (with leverage) and investment in physical capital.

The low cost of capital has generated a huge 'discount rate effect' on its intertemporal allocation – that is, an undue preference for some future goods and services and their related assets (e.g. tech-related and, arguably, housing as well) at the expense of other sectors.

The main cause of this artificially low cost of capital – and, hence, the distortion in relative intertemporal prices – has been a far too lax monetary policy. It has stimulated the financial sphere first (i.e. financial transactions per unit of money, or the financial velocity of money, which has accelerated in those economies where money has been injected), before reaching the real sphere. Due to this lag, one-off, temporary (though 35 years or so may seem long) disinflationary factors played a role and masked inflation in the real sphere for a time.

However, the low cost of capital has also masked the uncertain viability of business models in overinvested sectors, meaning that recessionary pressure will loom when over-capacities are unleashed down the road. At the same time, under-capacities in other sectors will generate supply problems and inflation. **Stagflation has its roots in this misallocation of capital and 'mal-investment'**.

I.2. Underinvestment in the old economy

One aspect of the ongoing regime shift is that the mantra and narrative of 'too much of everything' (overcapacity) is likely to be debunked. What is progressively being revealed is scarcity all around, beyond the energy sector, where it is a well-known fact. This has been under-commented on. Investment in aggregate was simply not enough. This is a core, non-incidental element of what we call the shareholder patrimonial macro-financial regime (or, in short, the 'shareholder regime'), which was initiated symbolically by the arrival of Paul Volcker at the Fed and is now coming to an end.

I.2.1. Under pressure from the shareholder regime

The structure of allocation and distribution of cash flow back to shareholders is part of the reason for this underinvestment in most sectors. Indeed, the focus on delivering high levels of Return on Equity (RoE) has gone hand in hand with an implicit preference

for primarily financial operations, such as high dividend policies, share buy-back programmes and M&A (often financed by debt) at the expense of capital expenditure (capex) and also wages. The broad macro-equation has been solved based on higher debt for households and corporations. **The low cost of capital has simply been put to work in the financial sphere rather than in the real one.**

A key reason for this preference for financial operations is that the discount rate effect, through the low cost of capital, has strongly influenced the net present values of assets' future income streams. This has shifted capital and cash flows away from generating new corporate assets – i.e. productive tangible assets in essential industries (or replacing the old ones) – and into leveraging existing assets. Rising existing asset prices on financial markets, given that they were a component of return on capital, have shifted the structure of the supply of capital towards financial capital rather than toward real projects. **The apparent fall in the cost of capital has not translated into stronger investment: this is a distinguishing feature and failure of this regime.**

No natural rebalancing forces intervened. Notably, Tobin's Q (i.e. the ratio of equity valuation versus the replacement value of real corporate asset) did not mean-revert, meaning that there was no surge in corporate physical capital despite the high market valuation of existing assets. Expectations of returns on corporate physical capital, against a backdrop of moderate economic growth, could not match those on financial capital.

Projects at corporate review committees have often wound up being rejected. Despite an effectively low cost of capital and prospects of returns on projects above this level, the projected cost of capital used in simulations proved much higher (up to 8%). This may reflect various factors. While risk aversion might have played a role at times, like in the vicinity of the 2008 crisis, it alone is not sufficient to explain the trend over the period. Such high numbers may also reflect the perceived opportunity cost of conducting fewer financial operations that would be more directly profitable to shareholders.

There have certainly been sectoral disparities in the capital accumulation process but there is no doubt about the larger macro picture. Fixed investment as a percentage of gross domestic product has been trending downward in the West: **while the Covid pandemic acted as an accelerator, the seeds had already been planted.**

1.2.2. Externalisation of capex only worked for a time

It is true that part of the capex effort has been delocalised throughout extended global value chains, particularly in Asia and with China at the forefront, where the cost of capital has been even lower. Nonetheless, taking this externalised aspect of capex into account does not change the overall downward trend. It just so happens that a peculiar historical coincidence has seen the combination of a powerful disinflationary Chinese platform and the pursuit of demanding financial objectives in the shareholder regime: the former has allowed the financing of the latter. However, this cannot be extrapolated into the future as, among other factors, this reality is now reversed.

1.2.3 The spectre of inflation is now looming

The surge in demand did the rest in the face of structural supply scarcities, leading to inflation after three decades or so of temporary factors that had masked it – and have reversed one by one. This awakening to scarcity as a lasting feature of the regime is difficult and still in its early stages. Trapped in their comfort zones, few saw it coming.

1.3. Overinvestment elsewhere

Aggregate underinvestment does not exclude overinvestment and/or ‘malinvestment’ in some areas. This is what happened. While bubbles were forming in more or less promising structural changes (internet, tech, etc), some vital simple needs were undergoing inadequate investment. The Covid pandemic suddenly unmasked that crucial needs could not be fulfilled in some of the most basic traditional sectors.

1.4. Consequences

1.4.1. No rapid fix

Hopes to see a rapid fix of the problem through an acceleration of investment are optimistic. It will take more time than expected to change approaches and reasoning that are deeply embedded in the corporate culture inherited from the previous regime.

As a new reality emerges from the Covid dust and the impacts of cyclical fiscal stimuli fade, it will become apparent that this legacy implies both long-lasting inflation and still-low potential growth. The current slowdown is already offering this message.

The already optimistic and demanding returns on equity inherited from this period (that have not been seriously revised) will soon face an even more difficult test, as will high valuations on risky assets in a context of rising rates (nominal first, then real).

An era of diminished financial returns, rising wages, and increasing cost of capital is about to combine with a massive and structural need for higher capex. Indeed, an accumulation of physical capital is needed to finance the energy transition at a time when global value chains are retreating back home driven by a set of reasons, notably rising security and sovereignty preoccupations.

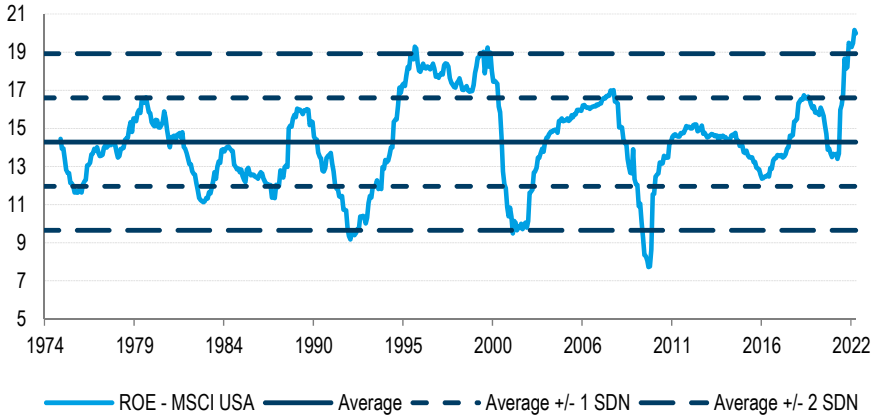
The energy transition requires investment that will not come from the Chinese platform. This transition is a macro shock with an intensity comparable to the oil shock in the ‘70s, implying an important reallocation of resources, employment, capital, and massive fiscal transfers. Public and private expenses will increase.

1.4.2. The incompatibility triangle of wages, capex and shareholder returns

Something has to give – and it will. The incompatibility triangle (wages, capex, and shareholder returns) in a context of inflation, higher rates, and the need to invest in the energy transition cannot be managed at the past level of RoE objectives. Public money

through higher deficits and bigger debt will arguably do part of the trick. Nevertheless, there must be a change on the private side too. At the same time, expect inflation and more humble RoE. Moreover, the Chinese platform will add to this reversal dynamic by exerting less downward pressure on interest rates and inflation. **The bottom line is that the regime of expected earnings must be revisited.**

Figure 1. Return on Equity, MSCI US



Source : Amundi Institute on Datastream, data as of 24 April 2022.

II. The shareholder regime is now ending, due to an emergence of forces that were previously absent

The shareholder regime of financial capital, supported by the Asian platform and business model, exerted downward pressure on interest rates and the cost of capital, favouring debt accumulation, abundant financial capital, and high equity valuations. However, this is now coming to an end with a new regime that intends to move wealth from savers to debtors, reduce inequality, and fix environmental issues seen as having arisen as a consequences of the previous regime (and reasons for which it can no longer be tolerated).

II.1. High unchanged returns on a rising stock of wealth, decline in the labour share: now reversing

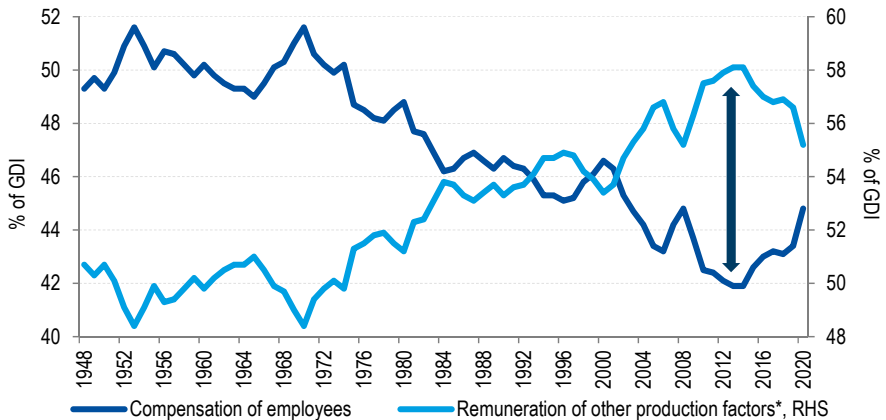
A prominent feature of the shareholder regime was that the decline in the labour share of income coincided with the rise of capital: this increase in the stock of wealth compared to income drove up the share of capital factor payment. The stock of wealth increased, as did the supply of financial capital, with unchanged (relatively high) returns on this stock of wealth (despite its increase) due to the

substitution between labour and capital. The falling reference interest rate and cost of capital has played a key role in distorting the allocation between labour and capital and, within the capital space, between financial capital ('wealth') and productive tangible physical capital.

It is true that the real rate of return on total assets has been higher than the real GDP growth rate not only in the past few decades but over a much longer period (1870-2015). This rate is a proxy for wealth as measured by a weighted average of real returns on bonds, equities and housing, weighted by the size of the respective asset portfolio (stock market capitalisation, housing wealth and public debt, equally divided between bonds and bills).

However, in the shareholder regime initiated in the 1980s, the increase in the stock of wealth saw an increase with no decrease in average returns. **This is consistent with the thesis of a shift towards financial capital at the expense of tangible physical capital.** Moving into an era of diminished returns on total wealth, a rebalancing of the relative shares of labour and capital, coupled with a higher remuneration of physical capital, would mark a shift with a possible pause or even a reversal of this long-term average historical regularity.

Figure 2. US shares of gross domestic income



Source: Amundi Institute based on Federal Reserve economic data, 23 May 2022.

* Other production factors include land, capital and entrepreneurship.

II.2. The role of the Asian-Chinese platform in the previous regime is also reversing

Devaluing currencies have been at the heart of the so-called Chinese platform and model. The accumulation of foreign exchange (FX) reserves, aimed at artificially maintaining the undervaluation of the currencies to support an export-led model, played an important part in depressing global risk-free rates through the buying of

Western debt (in the US in particular, financing the current account deficit), even before Western central banks (CBs) initiated quantitative easing (QE). In reality, the US was exporting investment assets that exceeded its domestic savings (current account deficit) through the recycling of excess reserves of Asian CBs. This 'chicken and egg' game has come full circle and maintained monetary accommodation at both ends of the axis, fuelling various forms of credit and asset bubble booms and bursts. Savings have been confused with money, and the so-called 'savings glut' has been exaggerated and instrumentalised.

This artificial fall in market (and therefore discount) rates has been taken as a structural and endless feature of the global economy, leading monetary and budgetary policies towards higher debt and lower policy rates. Moreover, pursuing an objective of accumulation of inputs (labour, capital and fixed investment) rather than an absolute increase in returns on capital, the Chinese platform has fuelled overcapacity and exported deflationary forces. In the West, this has contributed to putting the brakes on productive capacity (since others were doing the job) and led CBs to even greater accommodation.

The West miscalculated the fact that what was seen as a permanent structural feature of a globalised system (ensuring disinflation and low cost of capital) was not. **This false expectation led Western authorities to more accommodation, and particularly monetary complacency, than was required. Progressively, one at a time, the factors that stood behind this system are reversing, through the gradual emancipation of the Chinese model** (in fact, China is being, so to speak, 'removed' from the global architecture) both in terms of GDP structure (a shift towards internal demand) and geopolitical aspects (tensions with the US).

The West faces unintended and embarrassing consequences: higher inflation and rates, changing policies of emerging economies' CBs with less accumulation (the looming geopolitical 'weaponisation' of FX reserves following the Russian crisis adds to the trend), a shortening of value chains in relation to sovereignty or security issues, and the necessity to expand 'Green capital' which China cannot provide. A long but transitory sequence is coming to a close. Note, however, that the Chinese platform proved to be an external opportunity, and was not necessarily the main cause of the previous regime. Indeed, aside from the Chinese platform, the high RoE system within the shareholder regime has *per se* played a major role in the West, in the double compression of wages and capex.

II.3. Consequences: regime shift unfolding, and the end of a long but temporary exception

Things have changed. We stand at a juncture between long cycles of mean reversion between financial and physical capital. The current regime shift is pushing the West to inflate nominal variables (nominal GDP growth) through higher inflation to alleviate the cost of debt. It is in that sense that there is a preference for inflation.

II.3.1. Nominal illusions and reality

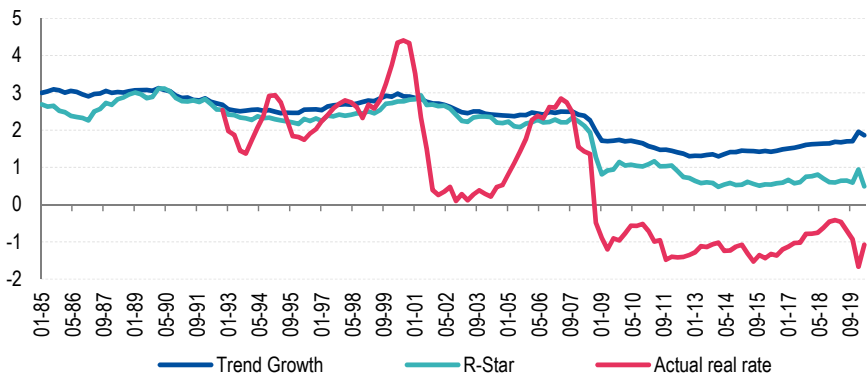
Nominal illusions will tend to mask realities. In an inflationary regime, nominal variables, such as growth, earnings or stock market revenues, are unsurprisingly inflated, whether willingly (through financial repression forcing low nominal rates) or not. The combination of real GDP growth at zero and nominal GDP at 10% makes a difference to how analysis should be run – certainly concerning earnings, but also credit default rates: after all, corporates reimburse in nominal terms. There may even exist the hope that extreme valuations can be bailed out through sufficiently high inflation and nominal growth. This is an important dimension of the new regime for investors. However, history hints at the opposite: all comparable periods have, first, seen a downward adjustment in valuations.

II.3.2. The narrative of a forever-low neutral/natural interest rate: just a narrative

In this journey into a new regime, we may realise that the narrative of a forever low neutral/natural rate (r^*) was premature and has anchored expectations of actual rates onto fragile foundations. This has indeed been a simple narrative, as r^* , a very important notion that has made a welcome comeback, is unobservable, difficult to define and to measure (like potential growth on which it is partly based), and therefore subject to biases and exploitation.

Indeed, actual rates, compressed over the course of 35 years or so by temporary forces, have been maintained below r^* . This has led to an underestimation of r^* (with frequent claims that it was even lower than conventionally assumed or expected) and the manipulation of the r^* notion through a comfortable belief in secular stagnation and structural excess savings, fuelled by the confusion of savings with money.

Figure 3. r^* for advanced economies, Holston-Laubach-Williams (HLW) estimates



Source: NY Fed, Datastream, Amundi Institute Calculations. The advanced economies aggregate includes the US, Canada, the Euro area (Germany for pre-Euro years) and the UK. The actual real rate is computed as the central bank's policy rate less Core CPI.

II.3.3. The end of the Great Monetary Consensus at the centre of the regime: shifts, tensions between objectives, and rising fragmentation

The dynamics of the previous regime have made monetary policy the hostage of financial markets for fear that a hawkish reversal would pressure asset prices, with negative macro spill-overs. At the same time, this has contributed to these dynamics themselves in a sort of reflexive feedback loop. At the current juncture, monetary policy now sits at the centre of tensions between, on the one hand, alleged support to financial markets and inflationary benign neglect and, on the other, powerful forces for a shift towards a better account of the real economy and physical tangible capital.

Moreover, the ongoing regime shift is unleashing forces of fragmentation in the monetary policy space with as many reaction functions as there are countries facing inflation. This largely reflects the end of a monetary consensus: a homogeneous set of principles (independent CBs; one tool, one objective type model) and rules (e.g. the Taylor rule). **The situation has moved progressively further away from a rule-based monetary system and into uncharted territories pioneered by QEs, various forms of debt monetisation, and a wider, undefined set of tools and objectives. The consensus has been broken.** In this transition of monetary policies, some credibility can only be lost and higher risk premia built.

As they wait for the monetary textbook to be rewritten, and for a new consensus to emerge, investors find themselves in a transitory and dangerous wilderness.

The US monetary policy business case: 1974 or 1983?

The US monetary policy case is illustrative of the end of the monetary consensus. While the debate regarding what actions the Fed should take (and with what consequences) is raging, there is neither a clear consensus nor real attention being focused on any sort of rule-based framework with which to define neutrality.

Two approaches to neutrality

According to the Taylor rule-based approach, the Fed is behind on the policy rate by at least 300bps. The forward guidance based approach (i.e. the fact that markets have already moved ahead of the Fed's effective action) shows the Fed is still behind, albeit less than the Taylor rule suggests, assuming that it will start delivering on its guidance to meet what is priced into the market.

Two precedents (same reading of PCE inflation)

In 1974, the Fed downplayed the monetary factors and focused its narrative on the non-monetary ones. It fell behind the curve while maintaining a relatively significant benign neglect. Consequently, inflation persisted above the PCE starting point and ex-post real rates remained low. The Fed was able to buy some time, but without changing the final outcome in the real economy (volatility and recession).

In 1983, the Fed changed its narrative to focus on the monetary factors. It did not accept falling behind and maintained a relatively low level of benign neglect. Inflation fell below the PCE starting point and ex-post real rates were relatively high, stabilising the real economy.

Where are we today? 1974, on balance

The Taylor rule-based approach makes sense and is an acceptable proxy for a 'terminal rate'. The Fed is arguably behind by more than 300bps given the leads and lags of policy transmission (the longer it waits to start hiking, the higher the terminal rate will have to be due to the time dynamics of inflation): but the policy system is no longer rules-based:

- Today, we are closer to 1974 than 1983. Despite its hawkish tone, the Fed's current narrative is not primarily driven by monetary factors, and the initial 'behind-the-curve' gap is similar to '74.
- Most likely, the Fed will stop hiking before completion of what would be needed in the Taylor sense, but the market can possibly do the rest (i.e. exceed the forward guidance).
- It is probably true that a genuine normalisation in the Taylor sense (or through markets endogenously exceeding the forward guidance and closing the gap with the Taylor-based measure) has a high risk of catalysing a recession because the Fed is already too late. Former US Treasury Secretary Larry Summers is right in saying that full policy normalisation implies recession, but wrong in the sense that full normalisation will not occur. Between killing inflation at the risk of triggering a recession now and buying more time for nominal growth to increase with a possible heavy price to be paid later, it is likely and human that the Fed will err on the latter side of the equation.
- Assuming no rapid Taylor normalisation or endogenous market excess beyond guidance, we are in a '74 scenario of higher, more persistent, self-perpetuating inflation, relatively low ex-post real policy rates for some time, but nominal market rates trending upward, with no avoidance of volatility in the real economy. Ultimately, recession is the end-game: it can be delayed, but it cannot be avoided.

History doesn't repeat itself, but it often rhymes.

III. Arriving in a new regime: takeaways for investors

The main legacy of the shareholder regime is inflationary structural supply constraints that combine with asset price (inflation) bubbles threatening to burst and insufflate deflationary type of pressures. This clearly points towards stagflation as the risk in essence of the new regime. Moreover, with fewer external sources of financial capital, the pressure on Western domestic savings will increase and so will the one on rates.

The new, more inflationary regime, with diminished returns on the stock of wealth and higher returns on physical capital, will also be coupled with a rebalancing, in favour of labour, of the relative shares of labour and capital.

For investors, this has far-reaching practical consequences:

1. **The RoE objectives inherited from the previous regime are unsustainable and will not be sustained.** The incompatibility triangle (wages, capex, high RoE) in a regime rapidly shifting towards higher inflation, cost of capital, and a need to invest for energy transition implies a change in the regime of earnings.
2. **If, ultimately, CBs do not prove serious about inflation, letting it run without raising real rates where they should be raised, time may be bought for risky assets. Yet, this will not change the end-game** – as either natural bond buyers will be forced to swallow bonds despite low real rates and hence sell risky assets or, eventually, market forces will push rates ahead of the curve and hit valuations.
3. Between the (a priori) deflationary bursting of a mature asset bubble and the unfolding and then extension of the inflationary cycle, it remains to be seen which will come first. The burst of the asset bubble may stop and even reverse the real economy inflationary cycle, but the inflationary cycle can also extend the asset bubble. **Yet, the most likely outcome may be that the inflationary cycle materialises together with the burst in inflated asset prices** as the dynamics of inflation, deeply entrenched in supply side considerations, are unlikely to be derailed by the bursting of a bubble confined to a limited scope of the global economy. All in all, the main risk is a case of full-blown stagflation – recession and inflation. Still, investors must play with the three options in their portfolio construction, possibly through time.
4. **Global fragmentation will be accompanied by the return of international diversification benefits.** The demise of the global monetary consensus as well as its corollary, the retreat of the unifying factor of global trade and global integrated value chains, will diminish the co-movement of global risk and the correlation of country returns.
5. From a sectoral perspective, investors should expect a change in the discount factor, itself driven by a change in how financial repression is conducted (from capping nominal rates at a low level of inflation to capping real rates letting inflation go higher). Growth and tech stocks were the winners in the previous regime. **Value stocks are the objective winners of the new regime.** Moreover, investors should pay closer attention to the sustainability of firms' business models. **They should turn towards less glamorous but more realistic and effective sectors,** rather than the tech stars of the previous regime, and focus on finding those that will thrive more under a high inflation regime.
6. In FX, we should not expect the previous system of Asian central banks' reserves making up for US insufficient savings. Investors should brace for many misalignments and tensions before a new order (probably less USD-centric) potentially emerges.

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