Lincoln Private
Investment Office
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Populism

"The Fed was largely responsible for converting what might have been a garden-variety recession, although perhaps a fairly severe one, into a major catastrophe ... Far from the depression being a failure of the free-enterprise system, it was a tragic failure of government."
Milton Friedman, Two Lucky People, 233 (on the Great Depression)

The success of Donald Trump, in spite of his many flaws both personal and political, has surprised the establishment. The status quo is no longer and the rise of populism is likely to continue following his victory in this election. His rise is a symptom of much deeper tension in the US, and indeed the rest of the developed world. To understand how we got here, we need to look back to the 1980s, the era of Ronald Reagan and Margaret Thatcher.

When the pair came to power at the beginning of the eighties they faced inflation at 10% and 18% respectively, taxes had reached record highs and economic growth had been stagnant for the best part of a decade. Both leaders implemented the policy of the "new right" which was to focus on lower tax rates, deregulation, liberalisation of trade and, most notable in Thatcher's case, privatisation. Both targeted improvements in productivity that had been slipping behind other developed economies.

This was the beginning of globalisation as we see it today, giving emerging market countries their opportunity to deliver cheaper manufactured goods, exposing developed market workforces to global competition, but also delivering greater capital efficiency and technological growth. However, many workers saw their generations-old professions being both automated and taken abroad. Reagan and Thatcher's policies eventually led to lower interest rates, which was the catalyst that led to a subsequent boom in household credit. This credit boom (exacerbated by the Clinton administration), ensured that those whose traditional sources of work had disappeared were able to console themselves with previously inaccessible cheap mortgages and car loans as well as low cost appliances from the far east.

Sharp financiers continued to innovate with more and more complex strategies. Cheap credit flowed to sovereigns, corporates and down to less than robust households, eventually leading to the 2008 financial crisis. Share prices fell fast and hard and the debt markets all but dried up overnight. Global investment markets priced in a potential financial meltdown. The immediate and coordinated response by central banks, led by Ben Bernanke (a keen student of the great depression, where there was a lack of policy response) was to cut interest rates and to introduce quantitative easing to increase the supply of money to the financial system. This was originally intended as a short term catalyst to drive growth and spur on lending. The expectation was that this increased supply would trickle down the system from the central banks to the financial institutions and on to the corporates and ultimately the consumers, who would quickly revert to their high spending ways and drive this much needed growth. However today, still in an environment of low growth, weak currencies and zero–to–negative interest rates, the beneficiaries of this strategy appear to be the wealthiest '1%'; the fabled "trickle-down effect" appears not to have trickled-down further.

What these ultra-low monetary policies have delivered to date is a rise in asset prices across the board, particularly in property, equities and bonds. The Gini coefficient (the most commonly used measure of inequality) has stretched even further with the owners of these assets continuing to get richer, whilst others have found it harder to get onto the ladder. Ordinary people have not been able to live off their earnings and have lost their jobs to globalisation. They are finding the system is no longer working for them, and they are questioning the status quo. Frustration has built up. Frustration that poured out in the recent UK referendum and that has defined the dynamics of this US election.

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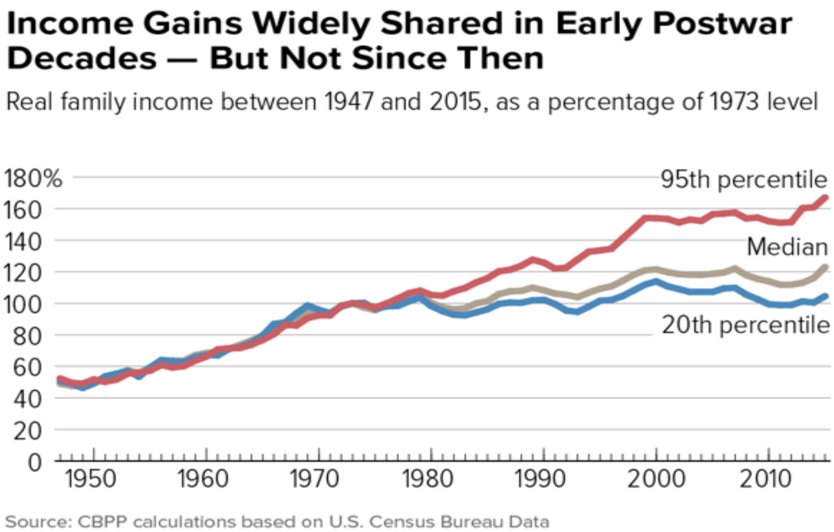
The chart below highlights that median incomes have stagnated since the 1980’s, whilst the top 5% have seen a meaningful increase. In the 30 years before 1980 the average American would have felt their relative wealth was rising alongside the wider economy, but this relationship appears to have broken down since. This trend has become more acute since the financial crisis, in particular with the top 1%.



Inequality has delivered the recent success that Donald Trump and indeed Bernie Sanders have seen. Both populists have gained prominence, not by intelligent detailed policies or new economic models, but by capturing the feeling of the people and by speaking to the disenfranchised American impacted by the ‘benefits’ of globalisation and an economy that no longer feels like it is shaped to their advantage.

In fact the average American sees a flawed system that appears to penalise saving, but encourages financial engineering and reckless spending. They have watched a period of share prices rising, in part due to firms buying back their own stock from money that they have borrowed from the Federal Reserve for next to nothing, benefitting shareholders and management, whilst workers’ earnings have not moved. They see private equity firms, hedge funds and high frequency trading firms skimming the excess cash from markets. They do not see the jobs being created, the wage growth and productivity improvements that are required for the outlook to feel positive. When asked in a survey in 2014 if life would be better for their children’s generation, 76% of those Americans asked said they did not think so (Washington Post August 12, 2014). Clearly something is not working; the improvements that should have come from globalisation, technological change and medical advances have not fed through to optimism about the future.

We expect to see a continued rise in populism and a continued questioning of globalisation on the world stage. The next clear sign of this may play out in the Italian referendum in December with the rise of more extreme political parties coming to the fore. We continue to believe in the benefits of globalisation and free market economics, but we need to foster an environment where the benefits are felt throughout the system. The social safety nets need to be in place to protect those impacted negatively from globalisation. This requires politicians to act in the best interest of the people that they serve rather than in their own best interests. This appears to be far from likely in the current climate, but perhaps this election result is the “shock” to make this happen.

We continue to favour emerging and Asian markets, as well as uncorrelated fixed income securities and gold. As the political environment globally becomes increasingly complex, we remain cautious about developed markets. It may be true that the easy money has been made since the 2008 financial crisis but for intelligent investors the dislocations we expect to see in the future will provide ample opportunities for returns.

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