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Reflation and the 3Ds:

Expect an Increased Focus on Capital Allocation, Quality and Sustainable Free Cash Flow

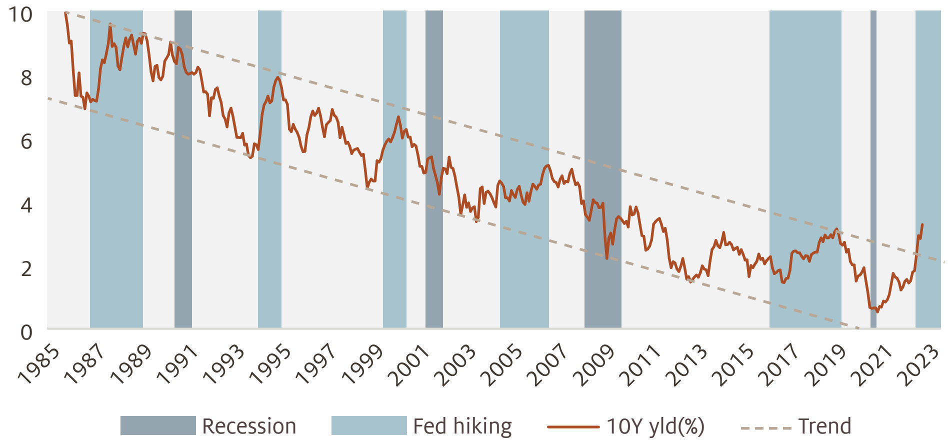
Kevin Hebner, PhD
Managing Director, Global Portfolio Management

William W. Priest, CFA
Executive Chairman, Co-Chief Investment Officer & Portfolio Manager

Until recently, we had been in a disinflationary environment since the 1980s, when Volcker helmed the Fed **(Figure 1)**. This secular trend reflected three forces: (1) Correcting the policy mistakes made in the '60s and '70s that stoked stagflation, (2) the increasingly globalized nature of trade, investment, and finance from the mid-1980s, and (3) the deflationary impact of tech, which has been especially impactful during the last two decades. While the latter factor remains in place, we believe it is being overwhelmed by the 3Ds — Deglobalization, Demographics and Decarbonization — meaning we have entered a secular reflationary environment. The remainder of this note briefly explains each of the three Ds and then concludes with a discussion of what all this means for investors.

Figure 1: The End of a Four-Decade Downward Trend

The 10Y yield has broken out to the upside, marking the end of the secular disinflationary trend.



Source: FRB, NBER, Bloomberg.

Deglobalization: Unwinding the Law of Comparative Advantage

The two decades from 1985 will go down in history as an unprecedented period of hyper-globalization. Trade barriers were reduced partially because of trade agreements (e.g., NAFTA, the European Single Market, the Uruguay Round), but the wave was led by developing countries in Latin America and Asia and formerly communist countries in Eastern Europe that undertook unilateral reforms.[1]

However, globalization has been in retreat for over a decade **(Figure 2)**, a trend we attribute to four developments: (1) China's mercantilist, self-reliance policies (e.g., China 2025 and Common Prosperity), (2) Western populists, whose influence has soared since 2016 (partially in reaction to China's policies), (3) COVID-19 which demonstrated how vulnerable we are to extremely fragile global supply chains (e.g., for access to Active Pharmaceutical Ingredients (API) and Personal Protective Equipment (PPE) as well as semiconductors and lithium batteries), and (4) Russia's invasion of Ukraine, which has particularly impacted trade in oil, natural gas and wheat.

> "Self-reliance is the foundation for the Chinese nation"
>
> *— President Xi Jinping, March 2021*

> "China's illicit trade practices — ignored for years by Washington — have destroyed thousands of American factories and millions of American jobs."
>
> *— President Trump, April 2018*

Of the four factors driving the trend toward deglobalization, by far the most important is China's mercantilist approach. This is best illustrated by their "dual circulation model" which emphasizes "international circulation" (moving up the value chain in exports) and "internal circulation" (expanding domestic demand). China's aggressive form of state capitalism increasingly promotes self-reliance (in energy, food, semiconductors, AI, batteries, lithium, rare earth metals, and so on), so that industrial policies rather than comparative advantage are what drives trade and capital flows.[2]

Adam Posen of the Peterson Institute emphasizes the world is set to look a lot messier, as it is increasingly bifurcated into two economic blocs: one aligned with U.S. and the other China. Even though the blocs won't include every country, and some countries will engage with both the U.S. and China, many countries will feel growing pressure to align with one or the other.

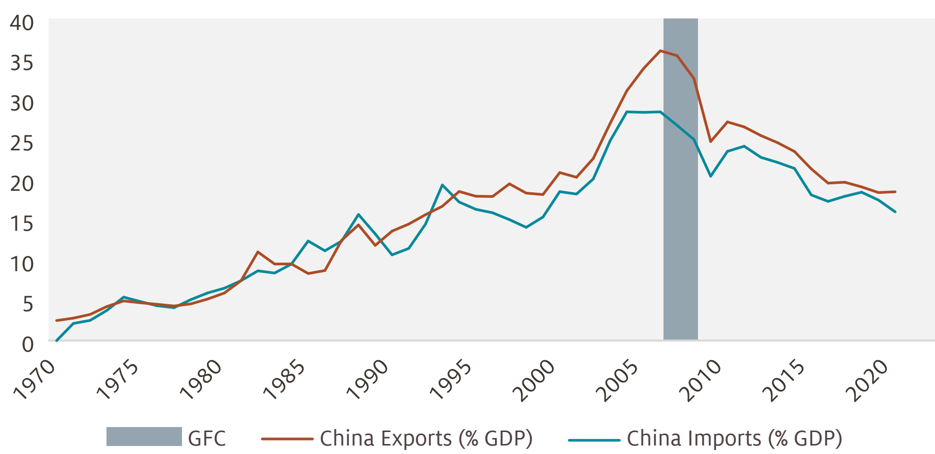
Dani Rodrik of Harvard stresses a paradox at the core of deglobalization. China has been the greatest beneficiary of the hyper-globalization game, but that is largely because it never had the intention of playing by the rules. Chinese policy makers put in place extensive industrial policies, provided huge subsidies to infant industries, tightly managed the RMB, restricted cross-border capital flows, and infringed on IP rights, all in violation of WTO rules. To Rodrik, China benefited so much from hyper-globalization specifically because it manipulated the rules of the world economy to its advantage, essentially free riding on the openness of countries like the U.S.

One direct consequence is that China will likely be deglobalization's biggest loser. This reflects dwindling export opportunities as well as China's waning access to advanced technologies, such as next-gen semiconductors. Moreover, decoupling will insulate Chinese companies, reducing competitive pressures and resulting in a less innovative and dynamic economy.[3]

Deglobalization has numerous implications, but here we'll just emphasize three. First, hyper-globalization has been deflationary **(Figure 3),** but we expect this effect to wane over coming years. Second, the China Shock reduced U.S. manufacturing employment and dampened domestic wage gains.[4] Although these trends

Figure 2: China's Trade (% GDP): Peaked in 2006

China was the biggest beneficiary of hyper-globalization, but Beijing's mercantilist policies have been the main driver of deglobalization.

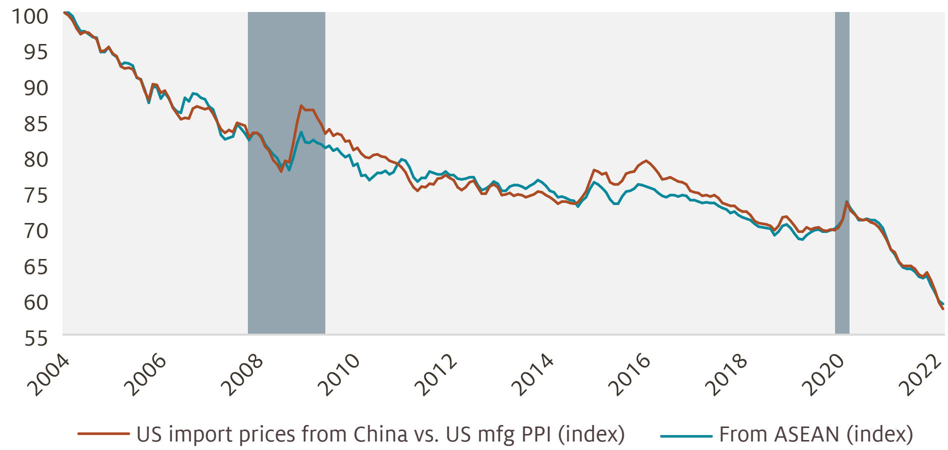


Source: Bloomberg, World Bank, NBER.

[1] *"The Trade Reform Wave of 1985–1995," Douglas Irwin, Dartmouth, 2022.*
[2] *Please see https://www.eipny.com/insights/trump-tech-and-trade/.*
[3] *Related themes are examined in https://www.eipny.com/white-papers/chinas-common-prosperity-what-does-it-mean-for-investors/.*
[4] *"On the Persistence of the China Shock" by D. Autor (MIT) et al, 2021.*

Figure 3: U.S. Imports Have Been Extremely Disinflationary

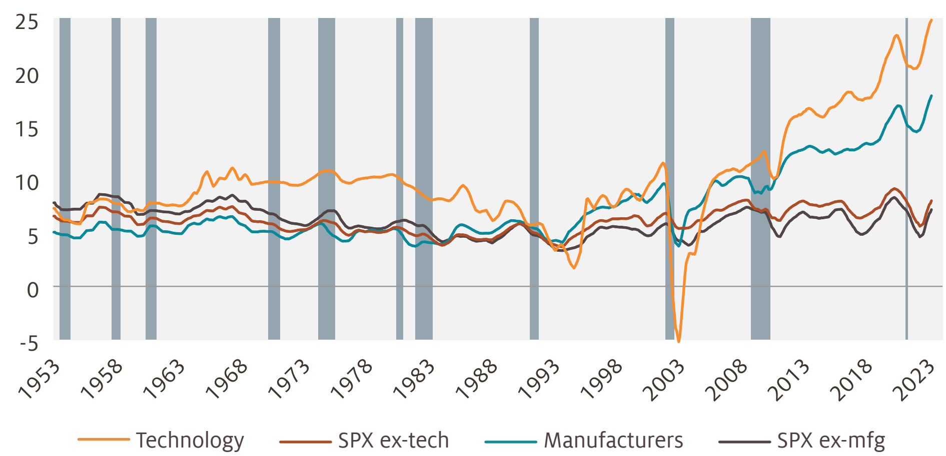
Since 2004 import prices from China and ASEAN have fallen by 42% relative to U.S. manufacturing PPI.



Source: Bloomberg, NBER, Empirical Research Partners.

Figure 4: SPX Net Profit Margins (%) — Soaring for Tech and Manufacturers, Stagnant for Everyone Else

Deglobalization is likely to mark the end of margin expansion.



Source: NBER, Bloomberg, Empirical Research Partners.

have been important since at least 2001 when China entered the WTO, they are likely to be at least partially reversed as America brings some jobs back via on-shoring and friend-shoring. For example, Goldman Sachs forecasts "Slowbalization" will boost annual core PCE inflation by 0.4 ppt, which strikes us as a reasonable estimate.

Third, corporate margins, especially for tech and manufacturers have been turbo-charged by four features of hyper-globalization: highly efficient supply chains, wage savings, lower interest rates and reduced tax rates **(Figure 4)**. With globalization in retreat, we expect margins to compress, especially for tech and manufacturing.

Demographics: Following the Path of Europe and Japan

Turning to the second "D," U.S. population growth is expected to average 0.6% annually this decade, half the rate experienced from 1950–1999. Moreover, the U.S. Census Bureau expects population growth to continue slowing during the following three decades. This partly reflects dwindling immigration growth, which has declined from 4.6% annually in the 1990s to less than 1% in recent years. A key consequence of these two trends is a rising dependency ratio (DR, the ratio of older dependents, over 64 years, to the working-age population, 15–64). The DR ratio is rising in all major economies, but its acceleration is especially notable in China and Europe.

Slowing population growth and a higher DR has a number of implications, including: rising public debt and deficits, lower top-line growth for corporates, and tighter labor markets which means stronger wage growth. The latter, which is also a feature of deglobalization, implies a higher labor share than was experienced last decade **(Figure 5)**. This share plummeted during the 2010s, falling to 58%, but is now moving up toward the historical range of 62–64%. We also expect a higher DR to induce a reduction in the savings glut, which will tend to raise interest rates across the board.

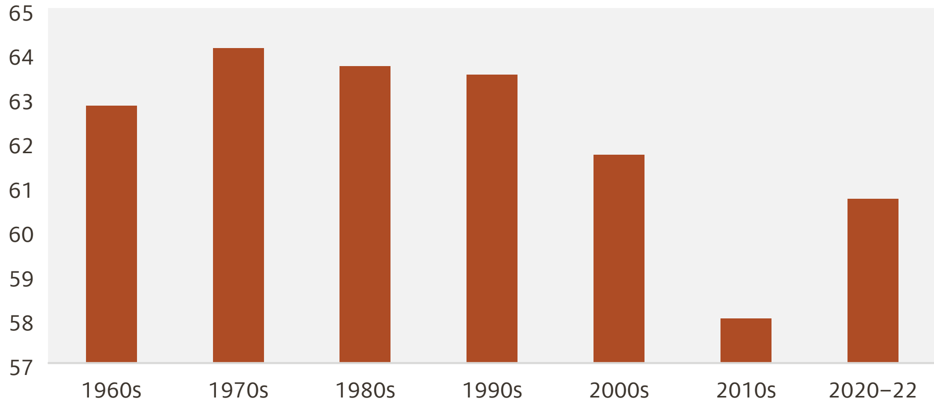
Decarbonization: The Energy Transition Will Prove Inflationary

This section briefly discusses the third "D" and the four reasons why we expect Greenflation to become a major economic force.[5] First, global capital investment in energy is expected to more than double by 2030. The energy industry has been under-investing since 2014, and the investments required in

[5] *For details, please see our March 2022 white paper, "Greenflation: The Energy Transition Will Prove Inflationary."*

Figure 5: Labor Share of National Income (%)

Plunged last decade after the GFC but is set to revert toward its historical range.



Source: U.S. Bureau of Economic Analysis.

electricity generation and infrastructure are emphatically massive. Further, the average capex intensity of low carbon energy is roughly twice that of hydrocarbons.

Second, the transition involves tremendous increases in demand for "green metals" (lithium, cobalt, nickel). The transition has only just started, but already the prices of most green metals have already more than tripled. Third, a pivotal feature of any plan targeting net zero emissions is carbon pricing. Although such a scheme is politically challenging in the U.S., the only alternative is command-and-control regulation, which is much less efficient and will result in consumers facing even higher energy prices.

Finally, most green technologies remain significantly more expensive than their fossil-fuel counterparts. While "Green Premiums" will decline with innovation and scale, in many cases this will take decades and until then, the transition involves higher costs and is inflationary.

Implications for Investors: Reflation and Greater Macro Volatility Implies an Increased Focus on Capital Allocation, Quality and Sustainable Free Cash Flow (FCF)

The next decade is going to look quite different than the 2010s when the 10-year yield averaged 2.4% and inflation trended well below the 2.0% target. We are saying farewell to the Great Moderation and opening the door to higher macro and inflation volatility. This includes more robust wage growth and a labor share that is elevated relative to the experience of the last two decades. For policy makers, this means less room for stimulus, both monetary and fiscal. Modern Monetary Theory (MMT) has been tossed in the dustbin, although the legacy of high fiscal debts and deficits is inescapable.

Investors should be prepared for lower top-line growth, as implied by each of the 3 "Ds." Moreover, margins have been turbo-charged by globalization and lower interest rates, trends which are now well behind us. This implies tighter margins for many sectors, especially tech hardware and manufacturing. Further, higher inflation and bond yields compared to the 2010s comprise a headwind for long-duration assets, including speculative tech, biotech, and venture capital. In addition to greater volatility and a foreceful rotation in sector leadership, expect equity markets to deliver lower prospective returns relative to that experienced since the GFC. With a "fatter and flatter" return profile, investors are likely to require higher equity risk premia and prioritize reliable earnings, which implies a focus on quality and sustainable FCF.