

What comes next?

It's not about pace, it's about direction

It is our belief that the set of investment opportunities and risks is changing. This development is not related to the pace of change, but instead concerns the direction of change. We view this to be a pretty big deal.

We don't have a crystal ball, no one does. We can't identify the winners and losers in advance. Nor can we determine future market turning points, market-timers always fail.

But we can say quite a bit about the drivers that will determine the future paths taken by investment markets and national economies over the next so many years. Why do we say over "so many years"? Do we mean over the short-run or over the long-run? Actually, neither. Instead, it's our understanding that this directional change (for investment opportunities/risks) will continue for whatever number of years (short or long) is required for the driving factors to become adequately reflected.

Drivers of change

We believe these drivers include:

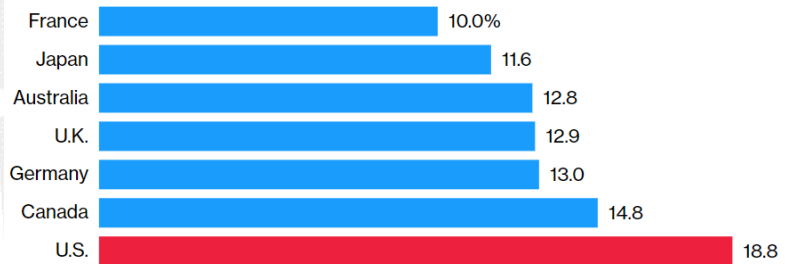
Renewable energy - The production/generation of electricity is shifting from fossil fuels to renewable energy sources.

Hases versus the have-nots - The "have-nots" are being continually bombarded with information about the gap between themselves and the "haves". Real-time communications and social media have turned this into a powerful force.

Top Class

The richest Americans take a bigger slice of the economic pie

■ Top 1% share of pre-tax national income

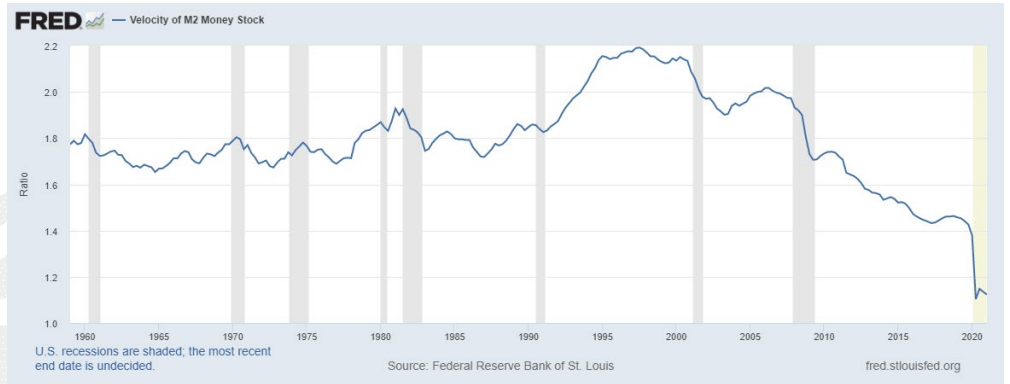


Source: World Inequality Database

China - China and the United States have entered into a multi-decade long cold war.

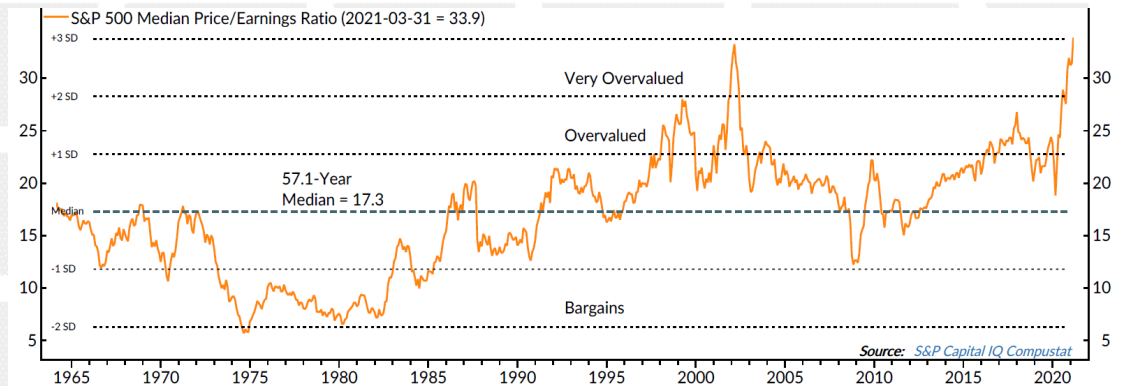


Velocity of money - The velocity of money has reached an unsustainably low level and will have to rise (significantly). This is important because its inevitable return to more normal levels may promote problematic inflation and undermine the Federal Reserve’s ability to pursue beneficial monetary policy.



Interest rates - Inflation-adjusted risk-free interest rates have reached unsustainably low levels and will have to rise (significantly). Today, a 10-year Treasury bond is paying about $-\frac{1}{2}$ % after inflation. Such a level amounts to Mr. Market saying “*Yay, the economy won’t ever grow again, and is in a permanent recession.*” In growing economies, inflation-adjusted interest rates remain positive - in other words, investors expect to get paid for lending out their money.

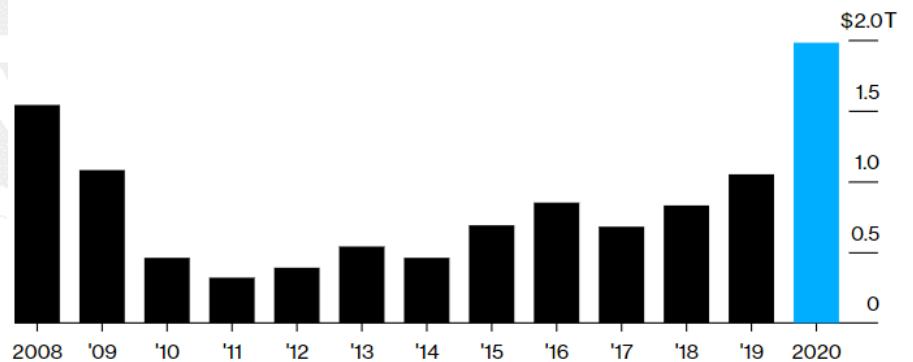
Valuations - The expected return for the most popular risk premia are overly compressed and will have to rise (significantly). In other words, valuations are stretched.



Zombies - There is an unsustainably high number of zombie companies, this will self-correct. Zombies are companies who are negative cashflow, and are only able to persist due to the temporary abundance of endless ultra-cheap credit.

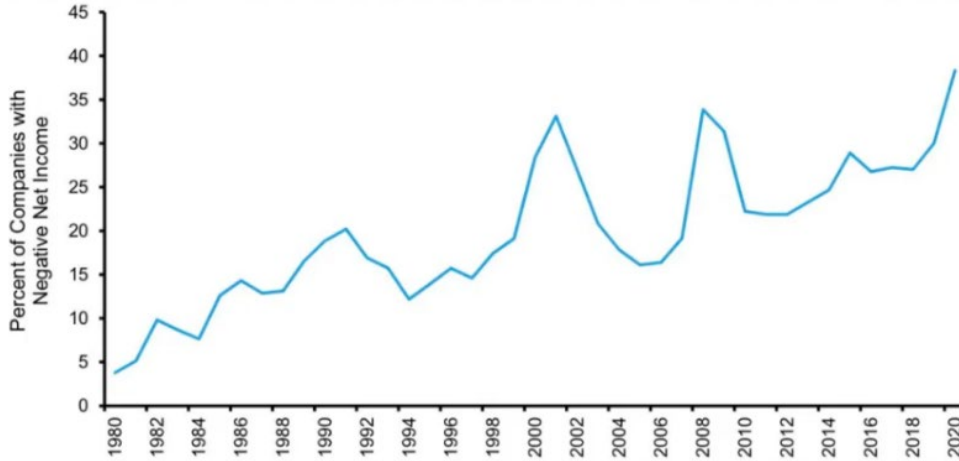
Undead Debt

Zombie firms are sitting on an unprecedented \$2 trillion of obligations



Source: Bloomberg
Note: 2020 figures are as of most recent quarterly data

Exhibit 5: Percentage of Companies in the Russell 3000 with Negative Net Income, 1980-2020

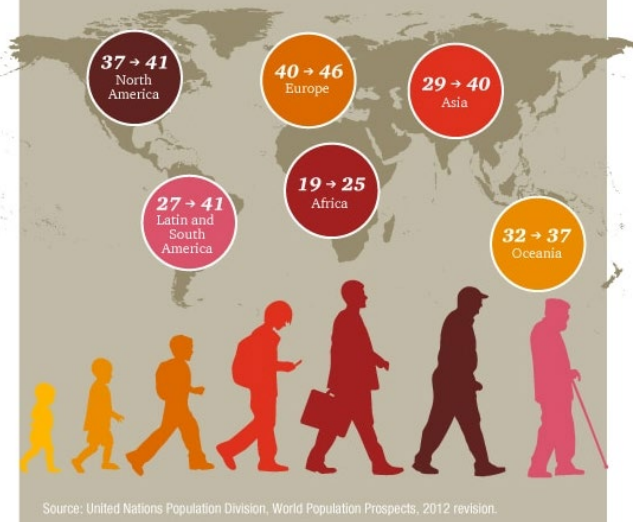


Source: FactSet.
 Note: Constituents of the Russell 3000 Index as of year-end.

Environment and demographics - Environmental and demographic shifts will result in a meaningful increase in geopolitical conflict.

The world's population in all countries will age...

Median population age, 2013–2050



Hoover Dam Reservoir at Lowest Since 1937 as Drought Worsens

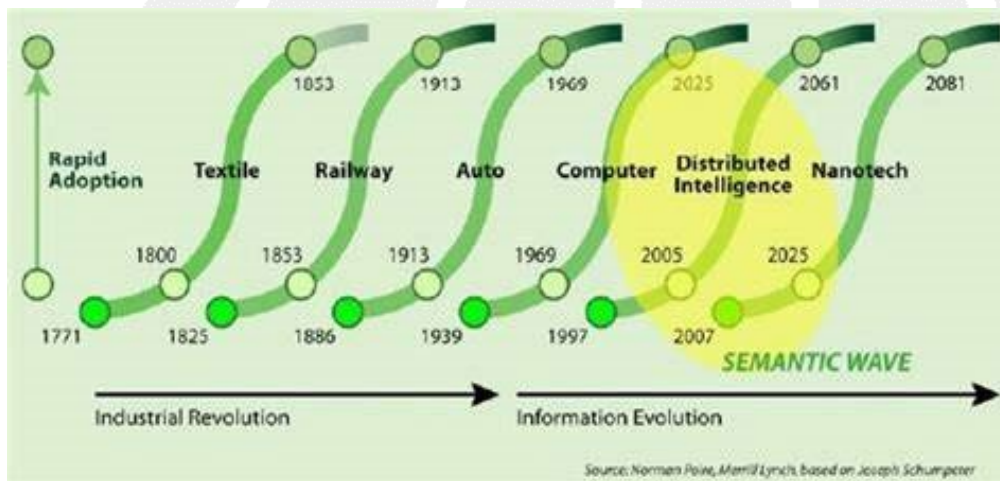
Creative destruction - There is a large and growing gap between those countries who maintain a robust ability to adapt, innovate, and engage in creative destruction . . . and those nations who are becoming increasingly rigid and inefficient as they attempt to avoid the pain of reinvention.



Creative Destruction is the essential fact about capitalism.

— Joseph A. Schumpeter —

AZ QUOTES



Future investment success

Directional change of this type and magnitude is nothing new, although we only experience it perhaps twice each century.

An important observation - Looking back at history, we appreciate that the opportunity for a successful investment journey is neither diminished nor made less likely during such turbulent times. Instead, as has been observed by others “*Change is the parent of opportunity*”. Our experience teaches us that future investment success is likely to require:

- Humility,
- Forward-thinking,
- Independent thinking, apart from the crowd,
- Forbearance against “*picking winners*” or “*predicting market turning points*”,
- Equal focus on possible market opportunities and potential market risks, and
- An appreciation that the future will be quite different from the past.

Conclusions and next steps

Anyone who attempts to peer into the future with the objective of divining the forces at play, must be willing to revise their conclusions as new information arrives - which it will.

Earlier, we listed nine drives of future change. Are these the ones that will prove out? No. Some will, while others will be replaced as, not yet discernable, new developments arrive. But the critical takeaway here, is that directional change is coming, and this implies the presence of a new set of investment opportunities (and risks).

Your financial advisor has a menu of possible investment solutions. The solution that is most appropriate to your unique needs and circumstances can only grow out of a meaningful discussion with your advisor. Reach out to them, talk with your advisor.

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