BANQUE
ERIC STURDZA

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INEQUALITY AND FINANCIAL MARKETS

"If you don't take change by the hand, it will take you by the throat", **Churchill.**

Before publishing our 2019 outlook for the global economy and markets in a few days' time, here we will answer a question that is frequently asked: Can widening inequality be attributed to financial markets? Yes, to the extent that since the 1990s, pressure from institutional shareholders has forced companies to squeeze costs and increase the return on equity. Yes, to the extent that quantitative easing, liquidity injections performed by central banks in the aftermath of the 2008 crisis, boosted prices of equities and real estate, which are investment assets owned mostly by the most affluent classes. But widening inequality has other causes, such as sluggish growth in the minimum wage and weak redistribution policies in the United States, insufficient skills of part of the labour force in countries such as Italy, and the low employment rate and structural unemployment in Southern Europe which can be explained by shortcomings of the education system or labour market rigidities.

The sluggish growth in real wages dates from the 1990s. For a long time, it was offset by easier credit. As noted by ***Boyer: "Lax credit appears to be a substitute for proper social welfare"***. However, the debt burden is reaching its limits.

In OECD countries, despite low productivity gains, firms' return on equity is increasing, but the trend in income distribution is unfavourable to wage-earners.

In several countries, opposition to widening inequality and the spread of populism are undermining democracies and creating further uncertainty in financial markets. When forecasting trends in financial markets, we must take into account new factors such as political instability prevailing over economic trends, and social destabilisation hindering the implementation of economic programmes in some countries.

We will endeavour to answer the question of a relationship between worsening inequality and the performance of financial markets first by analysing the consequences of shareholder pressure on listed companies since the early 1990s, and then by examining the consequences of the monetary policies implemented since the 2008 crisis.

I. Market pressure on profitability: Three aspects

- First observation: An inflection in income sharing between wages and capital

Since 1993, income distribution has been distorted in OECD countries, with a reduction in the wage share and an increase in the capital share. Wage-earners are less protected, trade unions are in decline, and at the same time institutional shareholders have placed increased pressure on companies to "create shareholder value". In the past twenty-five years, companies have increased their excess savings and often posted self-financing rates exceeding 100%. Dividends have increased and represent 4% of GDP in the United States and more than 5% of GDP in Europe, but investment has remained stable at between 11% and 13% of GDP, and wage growth has been slower than per capita productivity growth. For 2018 alone, when wages grew 3.1%, dividends increased by 9% to $500 billion, giving a 33% payout ratio.

A consequence of this stability of investment spending has been a decline in productivity gains and a slowdown in economic growth. A case in point is the sluggish growth in Japan, where, since 2003, companies have posted cash flows exceeding their capital expenditure, holding onto large amounts of cash and giving only small wage rises. This has adversely affected consumption.

- Second observation: Excessively high expectations regarding the return on equity

Under pressure from shareholders, return on equity requirements has been high, obliging companies to use debt leverage and the possibility of buying back their own shares. As a result, companies' return on equity has increased from 9% of GDP around 1998 to 12.5% at present. But such a figure ought to be a result and not an objective.

- Third observation: A decline in corporate tax rates

Due to competition between countries, many governments have reduced their corporate tax rates to increase their country's attractiveness. The most significant move has been seen in the United States, where Trump cut the corporate tax rate from 35% to 20%, representing a saving of $125 billion for companies and having an impact of 12 percentage points on post-tax profits, which rose 21% in 2018. He also levied a low 15% tax on repatriations of the $2,300 billion in capital held by US companies overseas. Such repatriations are estimated at $600 billion in the first half of 2018. However, the investment rate of about 10% has hardly increased, because the capacity utilization rate is not very high and the economic cycle is already at an advanced stage. The corporate debt ratio has not fallen either. And at the federal government level, financing this measure entailed an increase in the fiscal deficit to 3.9%, i.e. $779 billion in 2018, and a decline in welfare spending, because federal government revenues have fallen to their lowest level in the past fifty years, 16.4% of GDP.

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II. The consequences of monetary policies of liquidity injection

Historically, the role of central banks has been to supply liquidity to enable real interest rates to be close to real growth. Since 2003, and especially since 2009, their role has been extended de facto to maintaining the solvency of governments grappling with high debt ratios. Accordingly, central banks have kept an eye on long-term rates, and real interest rates are lower than real growth, thereby making the debt burden more sustainable and sometimes making it possible to reduce debt. We can analyse three facets of these monetary policies:

- Consequences of liquidity injection: ***"The good life in disastrous times", Camus***.

In the OECD, 10-year interest rates stood at 5% in 2000, while now, thanks to liquidity injections, they are less than 2%. And this has been very useful, because in the meantime the public debt of OECD member countries has increased from less than 70% of GDP to 115%.

Since 2008-2009, central banks, first the Fed and the Bank of England, then from 2012 the Bank of Japan and in 2015 the European Central Bank, have injected liquidity and lowered interest rates, and hence the cost of capital, to a level close to zero, lower than inflation and lower than the economy's growth rate.

On the economic level, this gave companies a new incentive to substitute capital for labour, taking advantage of low interest rates to borrow money. In the competition between production factors, capital, which is inherently mobile, is advantaged by comparison with labour, which is often less mobile. The over-accumulation of capital caused a decline in the marginal productivity of capital. By permitting relatively inefficient investments, monetary easing policies brought down potential growth, companies that were not very productive were able to survive, and overcapacity persisted, maintaining a deflationary environment.

On the monetary level, liquidity injection helped fuel real estate bubbles, squeezing risk premiums, causing a contraction in credit spreads, and leading to high valuations for investment securities, but not wage rises. Real interest rates have been low and often even negative since 2011, because, apart from the liquidity injection, the savings rate is high, and there is strong demand for risk-free assets (the German 10-year interest rate is 0.21%). Liquidity injection has also pushed nominal interest rates into negative territory in some countries, and this has penalized pension funds.

On the corporate level, cash-rich companies have not invested, but in 2018 they preferred to devote $1,200 billion to buying back their own shares, for the equivalent of more than 5% of GDP, following 4% in 2016 and 2017. They were thus able to raise their ROE from an average 6% in the OECD in 2009 during the crisis to more than 10% this year. Such buybacks are worrying, because they reflect a lack of ideas and are bankrolled by bond issuance. This suggests that the return on investments not made is less than the cost of capital, and it causes a contraction in the capital base, a reduction in the number of shares in circulation, and hence a stock market contraction. In the very short term, investors are delighted because the stock market rises, but longer-term, this shows that the stock market is playing a smaller role as a source of financing, because in 2018 the issuance-buybacks balance will be negative by 4% of the market capitalization.

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Of all the major central banks, only the Fed has pursued an active policy of interest-rate hikes, with nine rate rises since 2015, and this enables it to attract global savings to finance its debt and its current-account deficit, which will help it manage a turnaround in the economic cycle. The other banks are still conducting expansionary policies, with the Bank of Japan most aggressive. Since the end of the 1990s, interest rates have been close to zero, i.e. below the GDP growth rate, and since 2012 liquidity injection has been equivalent to 13% of GDP each year. Admittedly, the unemployment rate is at an all-time low of 2.4%, but the central bank continues to inject money. This policy has made it possible to easily finance a public debt which has increased from 1.1x GDP at the end of the 1990s to 2.25x now, and has permitted a depreciation of the yen, but has not been able to raise inflation to 2%. We have also seen stability of corporate debt at 1x GDP, of household debt at around 0.6x, and of the household savings rate at 5% of disposable income, and there has been no spate of inefficient investments.

Monetary policy is also very expansionary in Switzerland: the official rate is negative by 0.75% although the country has not faced a recession and it will post 2.5% GDP growth in 2018.

At a time when the ECB is preparing to keep negative interest rates but to stop its liquidity injection initiated in April 2015, an evaluation is not superfluous. The policy has indisputably been a success in managing risk premiums, and the level of long-term interest rates is low (consider Portugal, with a debt ratio of 135% of GDP and a 10-year interest rate of only 1.60%). It has also been successful in weakening the euro, even though all companies have not been able to increase their export market shares. Successful too in restoring profit rates, facilitated by lower interest charges, even though investment growth has been moderate. The weakness of the policy is a rather flat yield curve which adversely affects banks. There are question marks as to how the bank could act in the event of a turnaround in the cycle, because it will probably not have started to raise interest rates.

- Policies facilitated by the low level of inflation

Central banks have been able to prolong these policies of liquidity injection because they did not have to fear inflation. This is a far cry from the 1960s and '70s, a period characterized by wage indexing to inflation, and so-called "creeping" inflation. Pay rises are now exceptional. The reasons for this are a lower rate of trade union membership, an increase in the number of the self-employed and small service firms, widespread temporary work and an increase in the number of unskilled jobs.

- The independence of central banks in question? ***"The fact of delegating extensive economic powers to central bank governors seems to me absolutely contrary to liberal principles", Friedman*** in "Inflation and monetary system".

Central bank independence dates from the 1980s when it was necessary to be sure that inflation was being combated. At present, the inflation hydra has disappeared and central banks are unashamedly conducting expansionary policies that governments dreamed of, because by lowering the cost of debt, expansionary fiscal policies become possible.

It is easy to criticize, but it must be admitted that central banks' decisions undeniably made a major contribution to major economies' exit from the crisis, from 2009 in the United States and from 2012 in Europe. Recently, in Turkey,

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India and the United States, political leaders have tried to hamper this independence and curb interest-rate hikes, but without any success. So much the better, because however much central banks could have been criticised for their excessive liquidity injection, their determination to raise rates cannot be complained of. Everywhere, given the debt levels, interest rates are still at low levels. For governments, curbing interest-rate hikes is an attempt to postpone the end of the economic cycle, but it would also adversely affect central banks' capacity for stimulation during the next crisis.

Although independent, central banks have extended their role to vigilance on long-term interest rates in order to preserve countries' fiscal solvency. In the United States, the Fed is reducing its balance sheet by $50 billion per month, but it can decide to adopt a longer time frame in its re-investments.

Conclusion

- *Increased risks of protests*: The movement of revolt experienced in France will probably not remain a one-off event, although the country is characterized by one of the highest levels of tax pressure, at 35% of GDP including VAT. But welfare benefits, accounting for nearly one-third of GDP, are higher in France than elsewhere, the minimum wage is high relative to the median wage, the distortion of income distribution is moderate, inequality after redistribution is less than in many other countries and has not increased, while the percentage of people on the poverty line, at 13%, is far lower in France than in Spain or the United States, with 22% and 24% respectively. So let's bear in mind Churchill's words if we want to preserve liberal democracies open to the world.

- *Accommodative monetary policies remain essential*: In light of the very high level of debt worldwide, roughly 3x global GDP, i.e. 1x for public debt and 2x for private debt, monetary policies of massive liquidity injection should not be criticized too much, because by lowering interest rates they avoided a deeper crisis and higher unemployment. Even now, when unemployment rates are very low in most of the major countries, monetary policies still have an expansionary bias. However, we can see a reappraisal of credit risk ratings via a sharp increase in spreads on high-yield bonds.
- *Monetary policies need to be adjusted*: These monetary policies have led to a distortion of relative prices in favour of equity valuations and real estate valuations, benefiting the owners of assets and therefore increasing the inequality with wage-earners who have seen little change in their real income in the past two or three decades. After bottoming in March 2009, the US stock exchange peaked in mid-2018. The S&P 500 Index, which was at 666 on 6 March 2009, is now at 2506. The market capitalization of the US stock market, which fell to 60% of GDP in 2009, recently reached 1.4x GDP. The wage share of value added should be increased again and welfare spending should be concentrated on the least advantaged.
- *The stock market contraction*: Stock markets are no longer vehicles for corporate financing but are shrinking inexorably. In the United States, net liquidity (capital increases minus dividends and buybacks) is shrinking at an

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annual rate of 1% of GDP, and even 2% to 4% annually in recent years, while, as a result of mergers and delistings, the number of listed companies is diminishing rapidly. In Europe and Japan, the issuance-distribution balance is nil.

- *There is excessive pressure to increase ROE,* especially since the ROE is already far higher than the risk-free interest rate. The concept of value creation should not be restricted to shareholders, but extended to the company's employees and partners, customers and suppliers. It is therefore essential to make changes in norms regarding the return on equity. Share buybacks are excessive, because the fewer investments there are, the less productivity gains there are, and therefore less GDP growth. Excessive, too, is the "dictatorship of the markets" over central banks and governments. Excessive, lastly, is the US requirement of an earnings report each quarter, because it diverts companies' attention from a long-term vision.

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