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In a Down Cycle

The year 2020 has been one for the record books. It started off uneventfully on the back of a strong 2019 in the equity markets and amid the expectation of improved economic growth with the recent trade deal between the United States and China. The global pandemic quickly changed the outlook for 2020 and possibly beyond that too. The coronavirus scare started in January and by March global societies were in lockdown. Businesses were shut down and millions of employees were laid off. In addition to this health and financial crisis, the U.S. was also faced with social unrest of a magnitude last seen in the 1960s.

The impact of coronavirus on the U.S. equity market was dramatic as it dropped by roughly one-third in just over a month and crude oil actually traded briefly at an unthinkable -$37 per barrel. The damage to both equity and bond markets was, however, greatly repaired due to massive government fiscal and monetary stimulus and by the end of the second quarter of 2020 many markets had recovered much of their losses.

The future remains clouded with significant uncertainty about major questions:

- When will the coronavirus subside?
- Who will win the next election?
- Will we see more protests and more significant social unrest?
- What will happen to U.S.-China relations?

With such major issues looming, it is easy to think that we live in unique times. But is that true? A quick read through history would suggest the troubled times in our country are not unique and actually happen quite often.

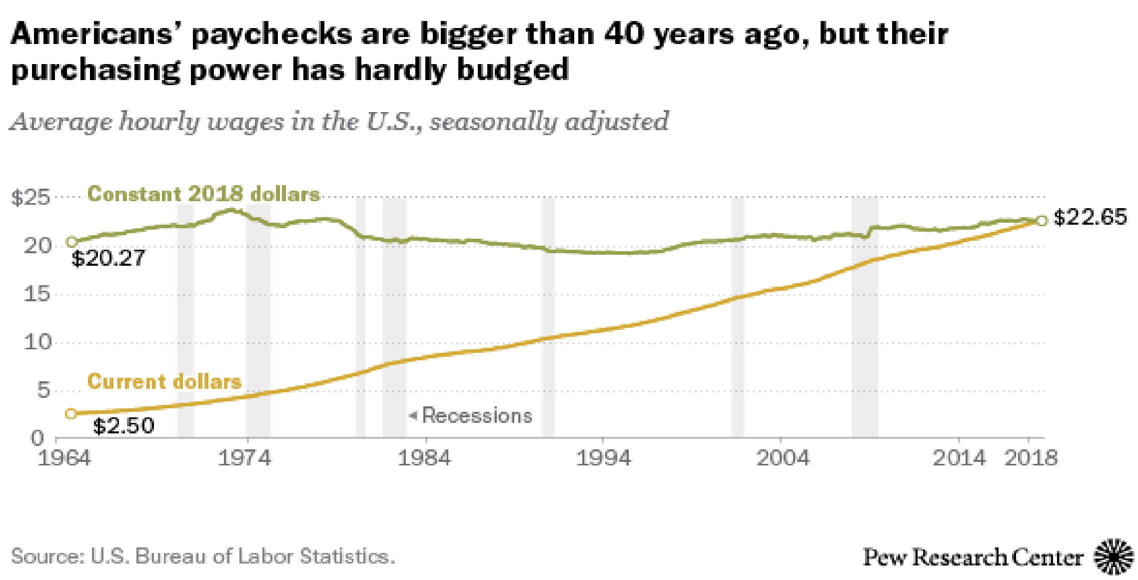
"Those who don't study history are doomed to repeat it. Yet those who *do* study history are doomed to stand by helplessly while everyone else repeats it."

In our last client letter, we discussed the pandemic through the lens of other pandemics in history. In this letter, we want to provide a perspective on the social unrest phenomenon, also from a historical perspective.

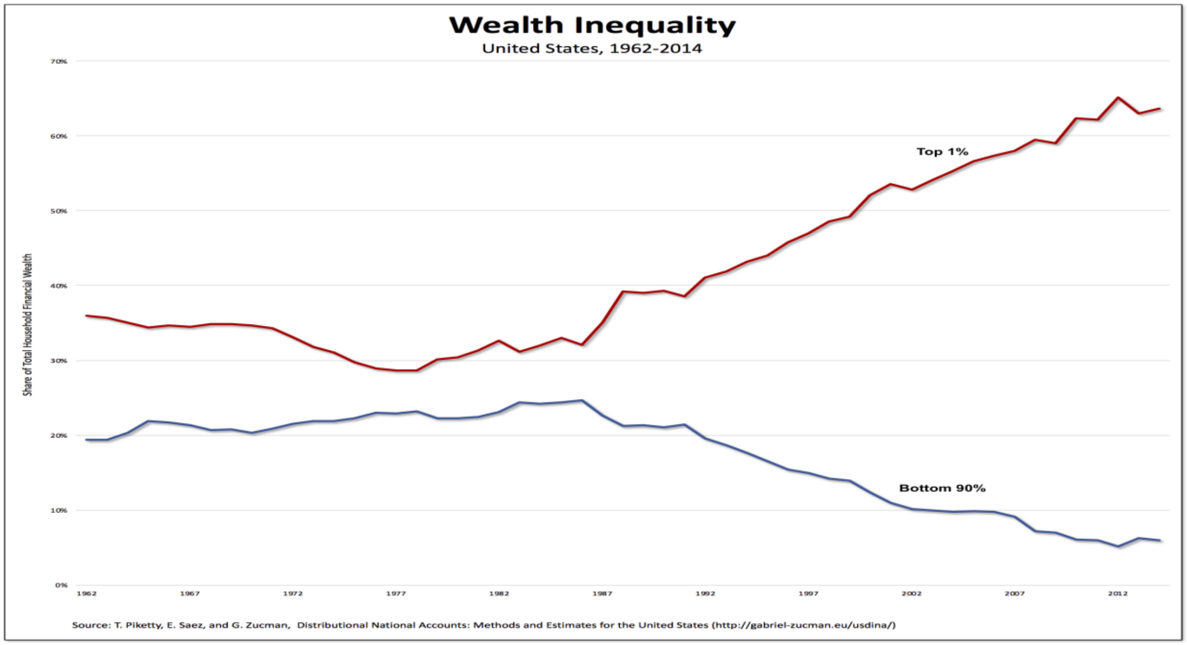
Over the last two decades we have experienced major economic crises and volatility in financial markets. Coincidentally, we have also experienced a long period of wage stagnation for the working class, increasing wealth inequality and increasing political tension throughout society. It is not surprising that social relations have become more tense and unpredictable. This is an environment likely to persist for some time.

Author and academic, Peter Turchin, arrived at a similar conclusion through the analysis of historical data associated with periods of social unrest. Interestingly, in 2010 he forecasted it was likely we would see significant social unrest in the United States around 2020. Turchin noted that "all complex human societies experience waves of political instability." These waves of political instability are typically preceded by periods of declining living standards for a majority of the population, the State facing a fiscal crisis and losing legitimacy, and rising geopolitical and global economic instability.

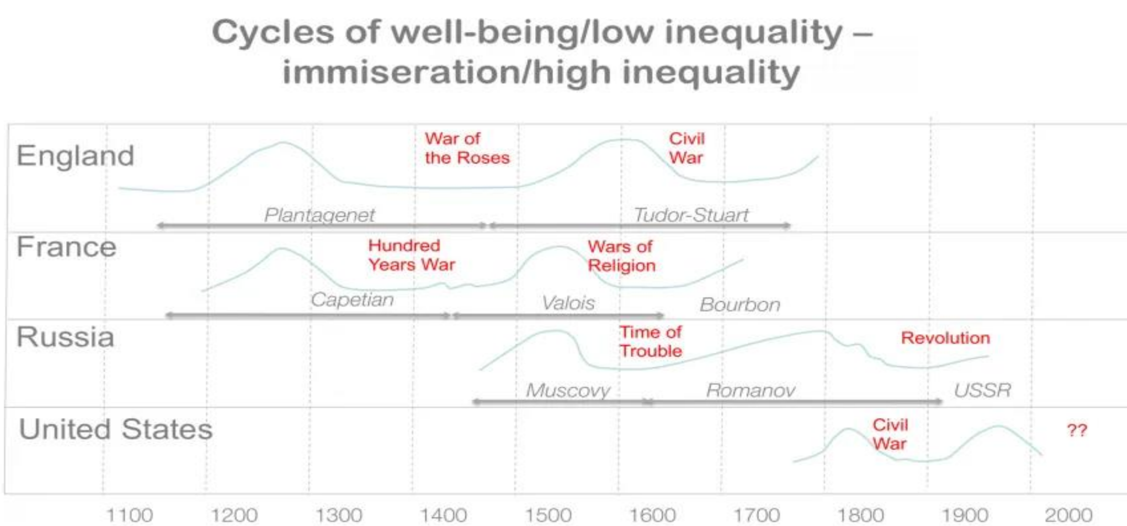
As the chart below shows, average hourly wages in the United States adjusted for inflation have barely moved since the 1970s. Things have not improved over the intervening decades for the average American.



And wealth inequality is a recurrent topic throughout society. As the chart below shows, we have witnessed a massive shift of wealth within the United States into fewer and fewer hands.



To round out Turchin's other indicators of social instability, the federal fiscal deficit through May was a massive $1.9 trillion[1], or $1.2 trillion more than last year, with increasing imbalances likely to come and geopolitical concerns abound as the United States has entered into a rocky period for its relationships around the world. Turchin also notes social unrest occurs regularly in a cyclical manner over time as well as throughout different societies, as we can see in the chart below.



Source: http://peterturchin.com/talk-slides/

[1] Wall Street Journal, July 8, 2020.

This cyclicality of rise and decline of societies was also noted by Strauss and Howe in their book, *The Fourth Turning*, which identified a dynamic in societies driven by the interplay of generations over time. According to the authors, over the last six hundred years Anglo-American societies have shown a tendency to go through regular cycles that encompass severe crisis, followed by recovery and decline, before returning to a period of crisis again. By their calculations, these cycles have similar characteristics and occur at fairly regular intervals, usually 80-100 years.

As long-term investors, it is important for us to have a sense for where we are in these long-term cycles even though we know predicting the exact timing of shorter-term events is not feasible. Accumulated evidence from recent years points to a difficult economic period ahead. Some elements of the evidence are as follows:

- Central banks' undue influence on markets to the point where prices of assets are artificial in that they are dependent on the willingness of the central banks/Treasury to print money.
- Extremely high debt levels at the government and corporate levels that makes it difficult to surmise how it would be repaid without significant disruption.
- A level of disparity in wealth and inequality that might provide the tinder for the fire of social discord.
- Increased geopolitical friction manifested by the frayed U.S.-China relationship.

The period of volatility that we are experiencing in our financial markets, economies, politics, culture and geopolitics is unlikely to end soon as the drivers of economic stress continue to build and the volatility in the social and political spheres look likely to increase. We, at High Pointe, are monitoring these economic stress points and their risks as we manage client portfolios. We continue to look for resilient companies with strong balance sheets to weather future storms, are avoiding investing in high yield corporate bonds, underweighting investment-grade corporate bonds, including gold miners in our portfolios, and using Treasury securities as a hedge as needed. Vigilance is the key and we are on guard.

Chris Olson and Gautam Dhingra
July 21, 2020