

## Weekly Market Flash

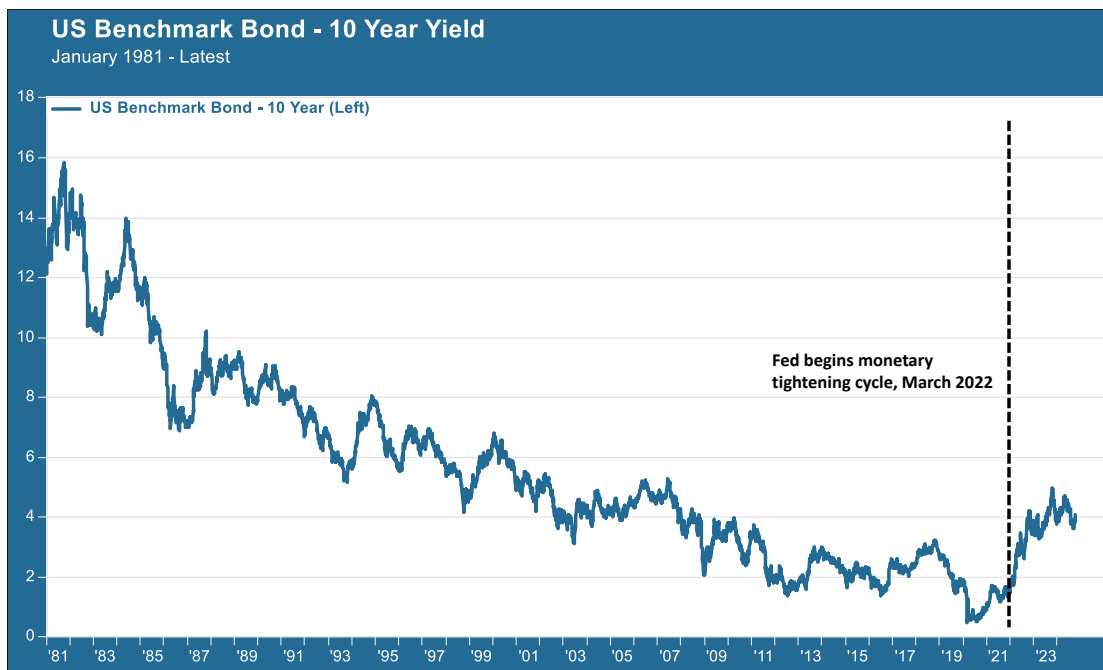
### When Tailwinds Become Headwinds

October 18, 2024

Yesterday we were participating in a panel discussion at a wealth management conference near Philadelphia, and the moderator posed an interesting question. Looking beyond the short-term environment of the next twelve months or so, he asked, what are the biggest structural concerns that keep you up at night? That's a question that rarely gets asked at these types of events, or really anywhere in the public financial discourse, where the conversation tends to focus on the immediate, the here and now of the Fed and monthly jobs reports and quarterly earnings calls. In a world where multiple news cycles can happen in a single calendar day, sometimes it is important to stand back, clear one's head and think about the bigger picture. Here is a brief digest of our answer to that question.

#### The Greatest Bull Market Ever

Let's set the table for this discussion with a focus on a multi-decade bull market. No, not the stock market of the late 1990s, or anything that happened in equity markets since then. We're talking about the bull market in bonds, which began in the early 1980s and persisted, more or less, through the zero-interest rate policy (ZIRP) world of the 2010s and again in response to the Covid-19 pandemic. The yield on the 10-year Treasury note, shown in the chart below, fell from mid-teens levels in 1981 to less than one percent at the height of ZIRP. Through multiple economic cycles and five recessions, rates for the most part kept going down, down, down.



Source: MVF Research, FactSet

#### Three Tailwinds, Working Together

That benevolent structural bond market environment was largely due to three enabling tailwinds. The first was the large-scale entry of women in the US labor force, a dynamic that began in the mid-1970s and

more or less topped out in the 1990s. The labor force participation rate rose from 59 percent in the early 1970s to 68 percent by the end of the 1990s. This had the effect of raising average household incomes – the dual-income household as the new normal – while at the same time keeping wage growth in check due to the added supply of job seekers.

The second tailwind took place in China, where the reform policies of Deng Xiaoping in the early 1980s brought about a massive migration of Chinese workers from their rural homes to big cities, where they became part of the fastest and most successful industrialization in history. This had the effect of sharply lowering the cost of labor. But it was the third tailwind – the globalization policies of economically developed nations in North America, Europe and the Asia Pacific Region – that opened up China’s supply of cheap labor to all corners of the globe. Eventually, globalization moved beyond simply access to cheap labor, and produced the complex industrial supply configurations optimizing all parts of the value chain from production to research & development, marketing and logistics.

### **Needed: A New Tailwind**

Those three tailwinds have largely played out, meaning that there is not much more in the way of new productivity to squeeze out of any of them. And the tailwinds are dying down at the same time as global population demographics are starting to emerge as a real headwind. In the developed world, populations are either growing at a rate below the natural replacement level (the US and much of Europe) or in outright decline (Japan). In China, some observers estimate the population could be as low as half its size today by 2050. The population mix is ageing, so whereas the dynamic in the 1980s and 1990s was more workers, the new environment is more (older) non-workers dependent on fewer workers to provide for them. The most likely structural outcome of this demographic shift will be persistently upward pressure on wages and prices; i.e., higher inflation. Not today or tomorrow or next year, necessarily, but likely within the time horizons of many of our clients and their portfolios. We will have to think and act accordingly.

Unless, of course, a new tailwind comes along, and here is where we had something of a spirited debate at yesterday’s panel discussion. Could that tailwind come in the form of the advances we are seeing in artificial intelligence? That is an open question with many opinions, but without a definitive answer as yet. However, we are starting to see some evidence of the productive effect AI can have even in some of the traditionally least productive areas of the enormous services economy. There are even stories (believe it or not) of AI interfaces that can resolve customer service problems with human-like reasoning skills, so that the customer would think that she is actually being helped by a live human. That may sound far-fetched to anyone for whom “customer service” evokes Dante’s eighth circle of hell, but imagine the large-scale benefits of it actually coming to pass.

We are in a transitional period now, with more hard questions and fewer definitive answers. That can indeed keep us up at night. But we also have been in this business for many, many years now. With the experience of time and observation, we continue to have confidence in our economy’s ability to adapt and figure out solutions to even the most serious problems. A new structural tailwind or two would certainly be a big help in that regard.

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