Insights
Active Quantitative Equity (AQE)

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Part 1: An Overview Of Secular Trends Shaping the Post-Pandemic Cycle

Michael Lin, CFA
Portfolio Strategist

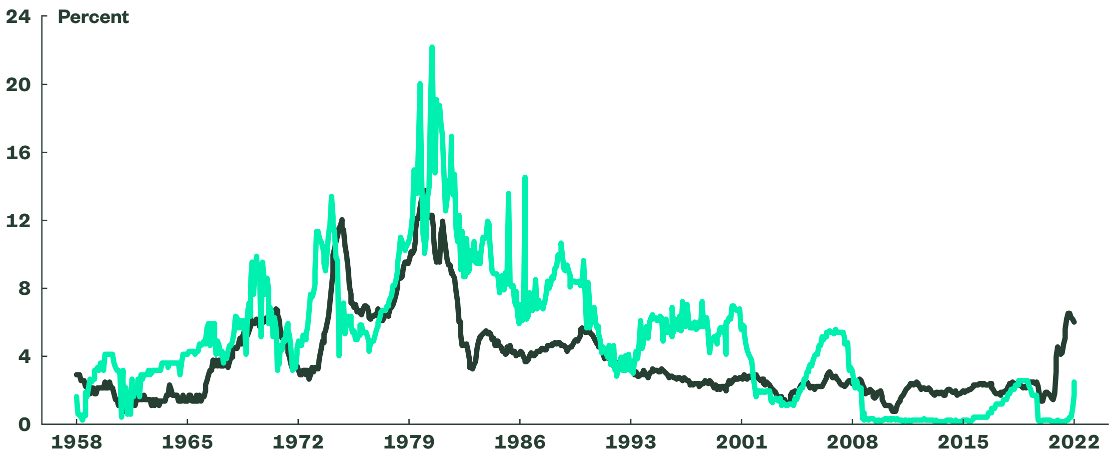
We believe that we have entered a new market regime; one that is characterised by higher economic and market volatility, and a higher 'resting heart rate' for inflation. We assess the cyclical and secular shifts that have led us into the current stagflationary environment, and touch on how these trends are likely to manifest themselves over the next cycle.

A Shift Away from Lower Forever Mentality

We believe that we have entered a new market regime, where cyclical and secular forces are shaping an environment that is different to the one we have experienced over the past decade or so. From a secular perspective, 'traditional economic cycles' of the 19th and early 20th century (pre 1980s) were generally volatile and short lived, reflecting boom and bust cycles and periods of high and low inflation and interest rates. On the other hand, the past 40 years represent somewhat of an aberration. This recent period was characterised by more predictability and stability in economic growth and inflation; as globalisation, technological advancement and independent central banks (forward guidance) contributed to more economic stability and sustained falls in inflation. With each subsequent interest rate cycle peaking at a lower rate than the previous one (as shown in Figure 1), investors eventually developed a 'lower forever' mentality and were conditioned to expect policy support whenever growth was weak.

Figure 1
Fed Funds Rate vs. Core Inflation

Core CPI
Fed Funds



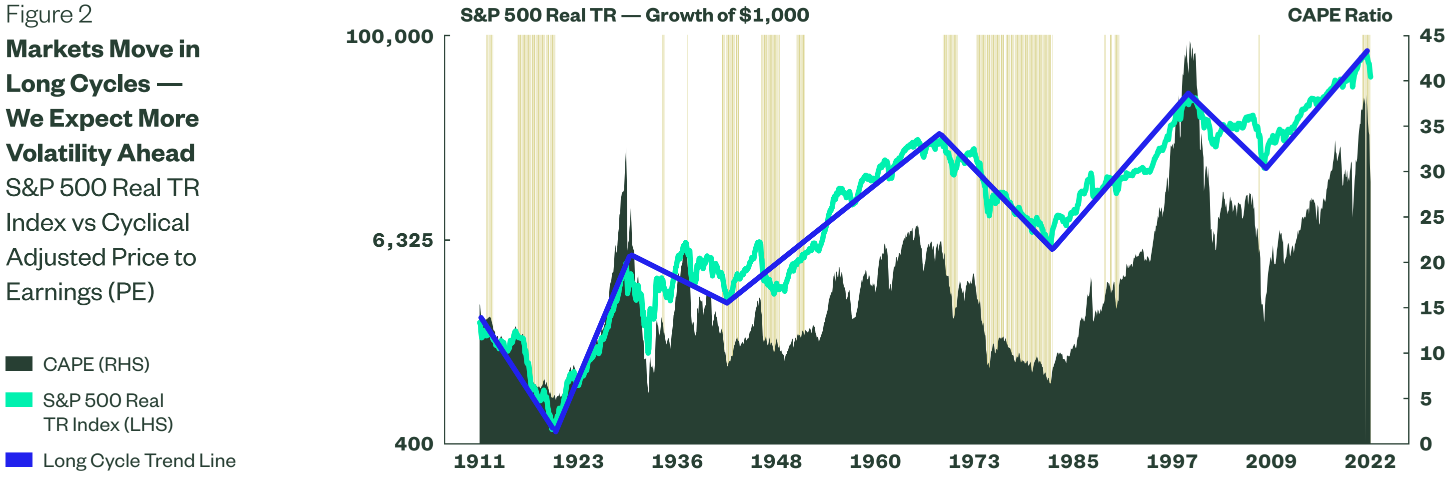
Source: FactSet, Federal Reserve, Macrotrends as at 31 July 2022.

As we exit the pandemic, investors are beginning to face a different set of macro conditions and priorities — which suggest the styles of investment and available opportunity set are also shifting. We believe the post pandemic cycle is likely to reflect elements of a more traditional cycle — with higher inflation and higher government intervention, combined with more extreme and fat-tailed outcomes arising from multiple sources: including climate change, healthcare crises, rising geopolitical/social tensions, deglobalisation and technological revolution.

Post Pandemic Cycle — More Inflationary and Volatile

Over the past century, equity markets have moved in long cycles, with multi-year bull markets following by prolonged bear markets. While long (or secular) bear markets often appear flat in nominal terms, once we adjust for inflation these bear markets become much more discernable.

Figure 2
Markets Move in Long Cycles — We Expect More Volatility Ahead
S&P 500 Real TR Index vs Cyclical Adjusted Price to Earnings (PE)



Source: Yale university, Robert J. Shiller, FactSet as at 30 June 2022. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

Figure 2 shows the S&P 500 Index in real terms, overlayed with the cyclically adjusted PE ratio (CAPE) and periods of high inflation. Unsurprisingly, secular bull markets normally start at points of low valuation (at the trough in real prices), with CAPE starting at an average of ~8x and expanding an average of 25x though bull cycles alongside economic expansion, rising investor optimism and periods of rational exuberance. Bear markets, on the other hand, typically begin with valuations stretched (with initial CAPE averaging 29x), and falls heavily (average -18x) during times of economic upheaval and prolonged periods of investor pessimism.

Historically, a multi-year correction scenario has always been associated with economic contractions. Markets generally don't bottom out until the economy is well into a recession and until policy starts to ease again. Furthermore, higher inflation regimes are associated with contracting market PEs, while more benign inflation regimes have been supportive of valuation expansions. Consistent with this historical pattern, the most recent long bull cycle was aided by a prolonged period of both economic and valuation expansion, assisted by a structural decline in long-term yields and low/stable price inflation.

The question of the moment is, of course, whether we are at the beginning of a secular bear market and how much volatility should investors expect to endure ahead?

A Volatile Transition into a New Regime

The reflationary policies applied during the pandemic injected massive amounts of money and credit into economies, and contained the 2020 market sell-off to a mere blip. However, as a result of those policies we are now facing the risk of a sustained period of self-reinforcing inflation. While central banks have committed to doing 'whatever it takes' to bring down inflation, the path ahead remains uncertain and dependent on how well they play their difficult hand.

For the first time since the 1980s, inflation has become a meaningful constraint for central banks. The "Fed put" is now at a way lower strike price than what most investors have been conditioned for in the post-Global Financial Crisis (GFC) era, and investors can no longer lean on the Fed to rescue asset prices. This change in central bank reaction function to market weaknesses presents a profound policy shift from those of the post-GFC era.

Over the next year or so, we expect disinflationary pressures to build as central bank balance sheets are unwound and the impact of higher interest rates filter through into lower economic activity. As earnings expectations adjust to ongoing inflationary pressures and its impact on margins, we expect inflation headwinds to shift from goods to services, and overall Earnings Per Share (EPS) in developed markets to contract rather than grow.

Secular Inflationary Forces and New Age Developments

In our opinion, a prolonged period of stagflation is unlikely, and there are important differences between inflation of the 1970s/80s and what we are experiencing today:

- There is no evidence of any meaningful embedding of inflation expectations today — making it much less 'entrenched'. Longer term inflationary expectations remains well anchored; with 5–10 year break-even rates trading at broadly the same levels as in late 2021.

- We are seeing evidence for easing supply chain bottlenecks, rising inventory levels and some demand destruction for goods.

- Today's economic structure is quite different — e.g. we live in a less energy intensive world compared to 40 years ago.

- Real wage growth is comparatively lower — In the 1970s, real wage growth was positive (supported by more favourable demographics), allowing most consumers to absorb the higher prices. Today, by contrast, real wage growth remains largely negative in developed countries.

- Technological disintermediation and rising wealth inequality further provide a level of background disinflation that makes the prospect of a 1970s/80s style stagflation more remote.

That said, we do not expect to see a return to the disinflationary experience of the 1990s–10s. While policy tightening is likely to slow inflation from where it has been, whether central banks can bring it back to what is discounted (~2.5%) depends on how deep the contraction is and how long it lasts. The current inflationary episode brings with it certain amount of 'inertia' in the form of wage growth and strong household balance sheets which will likely require a longer-lasting contraction to bring down. A prolonged period of restrictive policy stance will bring with it significant amount of economic pain and the risk of a hard landing over the short-term.

Over the longer term, the level of uncertainty is compounded by other important secular forces that are at odds with each other — creating structural inflationary pressures that will counteract existing deflationary pressures. On the inflationary side, we are faced with slow moving processes that will likely take decades to play out — including deglobalisation, energy transition, changes in production, and more frequent black swan events (e.g. climate change and geopolitics). On the disinflationary side, we continue to face the same disinflationary forces that were dominant over the previous several decades; including technological disintermediation, less energy intensive economies, more extreme wealth inequality and ageing demographics. These issues are sowing the seeds of instability and will likely require more government intervention in the future.

The intensity of current inflationary pressures will be exacerbated or curtailed depending on the amount of government and central bank intervention — via regulatory, monetary, fiscal, social or even military means. As policy responses push and pull, investors are likely to witness both inflationary spikes and periods of disinflation with higher oscillations around economic growth and market returns, along with heightened risk of an accumulation of policy errors. **On balance, we expect the structural inflationary forces in play now to more than offset the background disinflationary forces — resulting in a higher resting heart rate for inflation.**

How will these secular themes impact the investment environment? In some ways, a new regime of increased instability and volatility resembles the traditional economic cycles of the 19th and early 20th century. However, the underlying drivers of volatility will be different, and we expect completely new developments like ESG and decarbonisation to have a much greater impact on investment styles and opportunities available to investors. **Figure 3 summarises what we believe to be the most likely outcome for the forward market environment, and the associated style or factor preferences for systematic equities.**

Figure 3
Key Equity Markets Themes in the Post-Pandemic Regime

Pre-Pandemic Environment (Early 1980s–2020)	Post-Pandemic Environment (2021 Onwards)	Likely Impact on Equities	Style/Factor Preferences
Disinflationary	Inflationary	More volatile markets Less dependency on top-line revenue growth and long-dated cash flows Less persistent re-ratings/ smaller contribution from valuation	Value over Speculative Growth Shorter duration CF Lower Market Sensitivity
Falling Interest Rates/QE	Rising Interest Rates/ QT/“Whatever it takes”		
Less black swan events	More black swan events		
Globalisation/Cheap & plentiful labour	Regionalisation/Scarce & more expensive labour	More expensive labour More expensive inputs Higher Capex More focus on margin sustainability	Quality (e.g. margin sustainability)
More complex/efficient global supply chains (deflationary)	Simplifying supply chains — building resiliency (inflationary)		
Cheap & plentiful energy	Decarbonisation/Greenflation	More focus on climate change and associated capex	ESG Specific Factors
Decreasing capital intensity (e.g. Software)	Increasing capital intensity (e.g. robotics)	Greater investment into new materials (e.g. copper, nickel, cobalt etc) with associated periodic over-valuations	Value/Cyclicals (Capital goods)

Source: State Street Global Advisors.

In contrast to the valuation led bull market of the prior cycle, we expect the volatilities experienced so far in 2022 to continue as policy settings become more restrictive while demand and supply attempt to normalise. As higher volatility and higher inflationary impulses become the norm over the next cycle, we should not expect a particular investment style to work consistently over short periods of time. Over a longer timeframe, we are likely to see a more difficult environment for expensive, lower quality companies with greater leverage — as central banks can no longer be relied upon to inject liquidity at the first sign of trouble. Higher resting rate of inflation will also keep long-duration growth names under pressure.

In part 2 of this paper, we explore in greater detail the evidence that we are seeing for the secular trends outlined in Figure 3, and explain how a diversified portfolio based built on an intersection of alpha and risk mitigation is better suited to this forward environment.

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* Pensions & Investments Research Center, as of December 31, 2021.
† This figure is presented as June 30, 2022 and includes approximately $66.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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