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Rose-colored glasses

Blog

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Last week it was announced that Netflix will stream a spin-off of "That '70s Show" set in the 1990s, aptly titled "That '90s Show." The series may appeal to millennials and Gen Z, among whom 90s nostalgia is a hot commodity. But reading that announcement through a rose-colored market lens, I wondered if that's also a better name than "Roaring '20s" for the bull case scenario for this decade. If returning to 1970s-style stagflation is the bear case for the next five-plus years, then something analogous to the 1990s looks like the bull case: sustained growth above 2%, falling inflation and strong job growth as the decade proceeds, rapid productivity improvement, and revolutionary technologies that change the world.

That bull case almost sounds far-fetched right now. Yet earlier in the year many investors thought that a regime change to a scenario like this was a distinct possibility. It's worth reminding ourselves about the bull case after another high CPI print fans the flames of the stagflation bear case.

The following 10 factors are already happening or very well could, all of which support the possibility of the bull case. They certainly don't make this outcome inevitable and other factors matter, but they definitely put it within the realm of possibility.

1. **Positive aggregate demand shock.** The surge in demand for goods during the pandemic has been a big factor pushing inflation higher. But this demand shock may also help the economy break out of the secular stagnation regime of the prior decade. One explanation for this regime is that aggregate demand was too low and savings too high, keeping growth, inflation, and rates all low. A positive demand shock could spur a virtuous cycle of new investment and consumption that enables the economy to break out of this regime.
2. **Faster wage growth.** Rapid wage growth adds to inflation risk, but if it continues for low-income workers it could start to reverse the long trend of rising income inequality, which has contributed to secular stagnation. Wage gains that accumulate primarily to those in the top income deciles are more likely to be saved than consumed. But income gains among the bottom quartile are more likely to be spent, lifting aggregate demand and amplifying the initial demand shock.
3. **Public infrastructure and R&D boost.** It's likely that a USD 1.5–2tr budget reconciliation bill will pass before year-end, along with the USD 550bn infrastructure bill. Falling under the radar is another USD 250bn

bipartisan bill passed in the Senate to support competing with China. That bill allocates billions to R&D, semiconductor manufacturing, and tech hubs. Historical data shows a fairly high return on investment, measured by GDP impact over the long term, from infrastructure and R&D spending, so passage of these investment bills is a definite positive for long-term potential growth.

4. **A possible capex boom.** Capital expenditures have surged over the past year, in the US and elsewhere, and capital spending intentions remain high as production supply tries to keep up with demand. Exceptionally low inventories, supply bottlenecks, and producer prices that have risen faster than consumer prices should also catalyze additional investment. Consequently, US real investment is likely to reach 120% of its pre-recession levels a year faster than in prior cycles.

5. **Secular energy transition.** The global transition to clean energy and net-zero carbon emissions will require many trillions of dollars in public and private investment over the next two decades. The race to create a greener economy and the necessary infrastructure should be a boost to growth, all else equal, although also potentially inflationary as commodities remain in high demand as part of this transition.

6. **Surging new business formation.** For over a year, the number of new businesses being formed in the US is running 50% greater than pre-pandemic levels, averaging about 450,000 per month. Most are small businesses started by people dislocated during the pandemic, but some will grow into much larger companies. Just as important, this burst of entrepreneurial activity is injecting dynamism into an economy that has been lacking that attribute for at least a decade.

7. **Increased risk-taking.** In addition to increased entrepreneurship, people are exhibiting increased risk-taking by voluntarily quitting their jobs at unprecedented rates. In August, 3.6mn people did just that, according to the JOLTS survey—25% higher than any prior monthly total over the past 20 years. It's easier to quit when there's a record number of job openings. But that confidence can also encourage people to pursue riskier ventures knowing that there are fallback opportunities.

8. **Abundant access to growth capital.** A decade of low GDP growth has pushed investors to seek out secular growth opportunities in order to generate higher returns. The result is an abundance of equity capital available to firms of all types, from start-ups to newly public companies. According to Crunchbase, total venture capital funding in 1H21 was USD 288bn globally, shattering the prior half-year record set in 2H20 by over USD 110bn. The amount of capital raised through IPOs is also setting records.

9. **Digitizing business models.** One positive by-product of the past 18 months is that it has demonstrated proof-of-concept for how companies can successfully deploy technology to efficiently run their businesses in ways that they wouldn't have embraced without the pandemic forcing their hand. While companies used digital technology to run their businesses pre-pandemic, entire business models will increasingly be built around digitization, potentially resulting in greater efficiency gains.

10 **Faster productivity growth.** Measuring and forecasting productivity growth is notoriously difficult. But US real GDP is already above its pre-pandemic peak and is producing that amount with over 5mn fewer workers, which equates roughly to a 4% increase in real output per

worker in less than two years. Whether productivity growth in the 2020s will be above its anemic level of about 1% last decade is a guess. But the combination of increased private and public sector capital investment and R&D spending, greater use of digital technologies, and rethinking business models could unleash a productivity boom that echoes the late 1990s.

Not all, but many of these factors are likely necessary for the bull case to materialize. Another factor working against this bull case is time. It will take at least a couple of years for infrastructure spending, changing business models, and greater entrepreneurial activity to lift productivity and growth, while also potentially being deflationary. In addition, the supply-demand mismatch in the labor market could take multiple quarters to clear, and likewise with rejiggering supply chains.

By contrast, inflation just has to stay near current levels for another year for the bear case to materialize. While we think that's unlikely and not our base case, the outcome should become more apparent in six months. By then inflation will decline due to base effects, and supply chain bottlenecks should ease during the seasonally slower winter months. If that doesn't happen, the Fed will likely be more aggressive in hiking rates to cool the economy, increasing the recession risk.

The bottom line is that if inflation proves to be largely transitory, investors will need to spend less time reexamining what happened in the 1970s and more time thinking about the 1990s. Whether the fictionalized 90s show ends up being better than the 70s, time will also tell.

Appendix

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