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MARKET INSIGHTS

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THE GREAT DELUSION:

Are We Trapped in a Cycle of Change That Never Changes? A Forecast for 2025 and Beyond

The Mirage of Recovery: How We're Fooling Ourselves

As we emerge from the shadow of COVID-19, a narrative of robust economic recovery has taken hold. Yet, beneath this veneer of stability lies a disconcerting truth; the fundamental issues that plagued the global economy before the pandemic remain largely unresolved. French critic and journalist Jean-Baptiste Alphonse Karr's adage resonates deeply with our current economic landscape.

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> The more things change, the more they stay the same.
> - Jean-Baptiste Alphonse Karr

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The world has embraced the story of economic recovery, praising central banks for preventing collapse. However, this perceived stability masks deeper issues still afflicting the global economy. Efforts to stabilize growth since the Global Financial Crisis (GFC) have ironically resulted in greater financial market instability. The U.S. Federal Reserve's extreme interest rate hikes have not only heightened the unsteadiness but also further damaged an already struggling monetary policy transmission mechanism. This paradox underscores our economic reality, and the global economy has unsustainable debt levels not seen since the Napoleonic wars. We're in an age of fiscal dominance, where policy mistakes can metastasize into financial crises in the blink of an eye.

American economist Hyman Minsky's financial instability hypothesis is particularly relevant here. To paraphrase: "Stability leads to instability. The more stable things become, and the longer things are stable, the more unstable they will be when the crisis hits." The U.S. Federal Deposit Insurance Corporation’s (FDIC) 2024 Risk Review paints a concerning picture of financial uncertainty, pointing to unrealized losses on investment securities at the end of 2023. As interest rates rise, the market value of these securities falls, threatening regulatory capital ratios and liquidity management. Unlike the GFC, current losses are tied to investments in sovereign bonds and commercial real estate, underscoring the need for robust credit and interest rate risk management.

Monetary policy often creates an illusion of change. The Federal Reserve's strategies—interest rate cuts and quantitative easing—are losing effectiveness. Despite aggressive measures during the pandemic, these interventions are temporary and rooted in outdated practices. The banking sector, crucial for economic growth through credit, remains unstable. Banks' balance sheets are weaker now than after the GFC, casting doubt on the ability for interest rate cuts to stimulate growth.

The current economic environment resembles a liquidity trap, where high levels of debt, low interest rates, and low savings rates render monetary policy ineffective. Consumers and businesses hoard cash, stymying growth and complicating efforts to stimulate the economy. This scenario, aptly described as "pushing on a string," shows central banks struggling to drive growth when interest rates are near zero and consumer confidence is low.

Canada's Economic Reckoning

The Bank of Canada has already cut interest rates by 75 basis points, but the anticipated economic response remains to be seen. With an economy heavily reliant on real estate and lacking diversification, Canada faces a painful structural adjustment period that must prioritize private sector growth.

Canada’s economic challenges reflect broader global trends. Although the country’s pandemic response was commendable—providing over $230 billion in direct support for individuals and businesses—the aftermath is testing its resilience. Most notably, public sector growth has outpaced private sector job creation, raising concerns about long-term sustainability.

From February 2020 to June 2023, public sector employment in Canada grew by 11.8 per cent, while private sector jobs increased by only 3.3 per cent. This disparity raises critical questions about the sustainability of government expansion and its potential to hinder private sector development. In British Columbia, for instance, public sector jobs soared by 22.6 per cent, while private sector employment barely changed, rising by just 0.3 per cent. This intervention was made possible by Canada's pre-pandemic fiscal position, boasting the lowest net debt-to-gross domestic product (GDP) ratio in the G7. But this veneer of economic robustness is a cruel illusion, undermined by a shocking reality: Canada also carries the highest consumer debt relative to disposable income, exceeding a staggering 187 per cent. Canada's per capita GDP growth has not just lagged the U.S., it's in danger of plummeting below the Organization for Economic Co-operation and Development (OECD) average (0.3 per cent for the first quarter of 2024). Let's not pull any punches.

The implications of this public sector growth are significant. Critics argue that an expanding government workforce could crowd out private sector job creation, ultimately undermining overall economic productivity. If this trend continues, it may lead to continued fiscal irresponsibility and potentially higher taxes, further affecting capital formation and private sector vitality.

In response to these challenges, the Liberal Party has appointed Mark Carney as Chair of the Leader's Task Force on Economic Growth. He will spearhead efforts to create a restructuring plan focused on both immediate and long-term growth and productivity. Carney intends to engage Canadians, seeking insights from experts in the business community, labour movement, and Indigenous leadership through a series of meetings and events aimed at gathering innovative ideas.

Carney emphasizes the need for a pragmatic and impactful vision, stating, "The world is becoming more divided and dangerous, but Canadians' hard work can help us navigate these challenges and capitalize on the opportunities in the new global economy."[1] He believes that with a strategic growth plan, Canada can take meaningful steps towards becoming the strongest economy in the G7, ensuring a brighter future for all. A balanced approach is essential—one that embraces fiscal responsibility and targeted growth initiatives. By diversifying the private sector, Canada can better compete in this new digital age.

This initiative represents a crucial first step, acknowledging that significant changes are necessary for Canada's economic sustainability. While these may be baby steps, they indicate a commitment to forging a new path for the country.

For investors, the interest futures market is forecasting the Bank of Canada overnight rate to be in the 2.75 per cent area by early summer 2025. A rally in interest rate-sensitive areas would not surprise. Gold and gold stocks should support the S&P/TSX Composite through this period, as they did in the early 1990s. Eras of fiscal irresponsibility, and global reflation, are conducive to gold and bitcoin appreciation. However, it's folly for investors to ignore the hard reality of the structural changes that Canada needs to compete in the new digital world. As these realities set in, risk assets may well continue to lag their U.S. peers, but still be pulled along by a risk-on trade until late 2025. But alas, the stock market is not the economy.

The Inflation Illusion: Why Deflation Remains the Real Threat

Despite recent concerns, there are compelling reasons to believe that the world has not entered a new inflationary era. Several factors continue to exert deflationary pressures on the global economy:

- High debt levels in many advanced economies act as a deflationary force.
- Technological advancements continue to maintain deflationary pressures.
- China is experiencing and exporting deflationary pressures globally.
- Demographic factors may not necessarily lead to sustained inflation.
- The global economy faces challenges, including weak demand and ongoing uncertainties.

Today's economic landscape strikingly resembles a wartime economy. With fiscal deficits soaring past eight per cent and debt-to-GDP ratios nearing 125 per cent, we're on the brink of a significant shift. Historically, transitioning to a peacetime economy—like after the First and Second World Wars—has required fiscal austerity. Recent signals from the U.K. and Italy hint that such measures might soon be inevitable. The status quo is unsustainable. We are entrenched in an era of fiscal dominance, where unchecked government debt threatens to devalue the U.S. dollar and render traditional monetary policy tools ineffective. As the economy slows and deflationary forces strengthen, central bankers will need to shift their focus to growth.

If the U.S. government continues accumulating debt at a rate of US$1 trillion every 100 days, projections suggest

[1] Mark Carney to Chair Leader's Task Force on Economic Growth, Liberal Party of Canada. Press release, September 9, 2024.

national debt could surpass US$50 trillion by the 2028 election. In this precarious economic environment, a strategy that emphasizes a balance between equities—characterized by strong low-volatility factors—and secular growth, alongside gold and bitcoin, emerges as a compelling enhancement to investment portfolios.

Artificial intelligence (AI) is poised to revolutionize economic growth by enhancing productivity and efficiency. However, this promise isn't universally felt; sectors reliant on interest rates and consumer spending are showing signs of strain. Dan Ives, Managing Director, Equity Research at Wedbush Securities, presents a compelling thesis on the multiplier effect of AI spending, particularly focusing on NVIDIA (NVDA). For every dollar spent on NVIDIA's graphics processing units (GPUs), there appears to be an $8 to $10 multiplier across the industry, amplifying economic activity.

The long-term theme remains; will market emotions overshadow fundamentals? Can increased AI capital expenditure help the U.S. avoid a recession? In a winner-takes-most landscape, we must consider the strategic risk of falling behind in AI and whether these risks outweigh immediate concerns.

The Reckoning: Navigating the Inevitable Economic Reset

With soaring debt-to-GDP ratios, deficits surpassing eight per cent, and inflation hovering near target, the Federal Reserve finds itself in a precarious position. The Federal Funds Rate (FFR) is currently at 5.375 per cent, while the natural rate of interest (r*) is estimated to be around 2.5 per cent. An inverted yield curve signals potential economic distress. The Fed must act decisively to align the FFR with r* to avoid exacerbating stagnation. Recent data showing a GDP growth rate of three per cent masks the instability of the private sector caused by high interest rates. Moreover, significant downward revisions to the Bureau of Labor Statistics' job numbers—over 800,000—linked to the birth/death assumption raise questions about the data's reliability. This discrepancy suggests that other measures may present a more truthful picture of the economy's health, particularly given the fiscal deficit and sluggish growth.

We are entering a period of slowing economic growth and persistently low interest rates. Investors should pay attention to the warning signs. Interest rates are forecast to bottom out in mid to late 2026, dropping below two per cent. Due to lags in monetary policy of at least 18 months, rates will remain low for an extended period. Analysts predict that S&P 500 earnings will rise by 15 per cent in 2025, reaching just over US$279.00, followed by another 12.5 per cent growth to US$315.50 in 2026. If these forecasts prove accurate, the S&P 500 could approach 7,000 by late 2025. However, it's crucial investors pay attention to when the second derivative of growth turns negative, as risk assets have historically responded adversely in such scenarios. Fiscal austerity and potential trade wars could render 2026 earnings forecasts overly optimistic.

A slowing global economy will exert pressure on oil prices. However, with the Strategic Petroleum Reserve (SPR) needing replenishment, crude oil is unlikely to fall significantly below $60. As the Federal Reserve cuts rates, both gold and bitcoin are expected to perform well, leading to a temporary increase in market breadth. The AI theme is expected to drive solid earnings growth into 2026; however, as growth concerns increase, low-volatility companies should attract capital. While the U.S. leads in innovation, Canada faces challenges due to high exposure to real estate and private sector debt levels.

What Should Investors Do

Despite these long-term concerns, risk assets will likely perform well until mid to late 2025. As a strategic recommendation, proactive investors should consider beginning to harvest gains after the S&P 500 surpasses the 6,500 level. In this environment, a barbell investment approach focusing on secular growth and low volatility quality factors is advisable. Sovereign bonds look appealing as the FFR is expected to reach r* faster than consensus forecasts. The trade will be nuanced: as the Federal Reserve cuts rates, investors may wrongly assume issues are resolved, causing short-term rates to fall sharply while long-term rates still fear inflation. Once investors realize growth is slowing and rate cuts solve little, the long end will drop, flattening the yield curve.

While the surface-level narrative suggests economic recovery and stability, a deeper analysis reveals persistent underlying issues that have yet to be adequately addressed. As we move towards 2025 and beyond, investors and policymakers alike must remain vigilant and prepared for the potential economic challenges that lie ahead.

Indeed, "The more things change, the more they remain the same." The cycle of change that never truly changes continues, and the great delusion of progress without fundamental reform persists. The unresolved structural issues that contributed to secular stagnation and deflation before COVID-19 still loom large. Unless policymakers and investors confront this reality, we risk repeating past mistakes. It's time to recognize that nothing has truly been fixed; we are heading back to a world dominated by extreme levels of debt deflation and stagnation. Acknowledging this is crucial for breaking free from economic stagnation and pursuing sustainable growth.