Structural Changes, Anyone?

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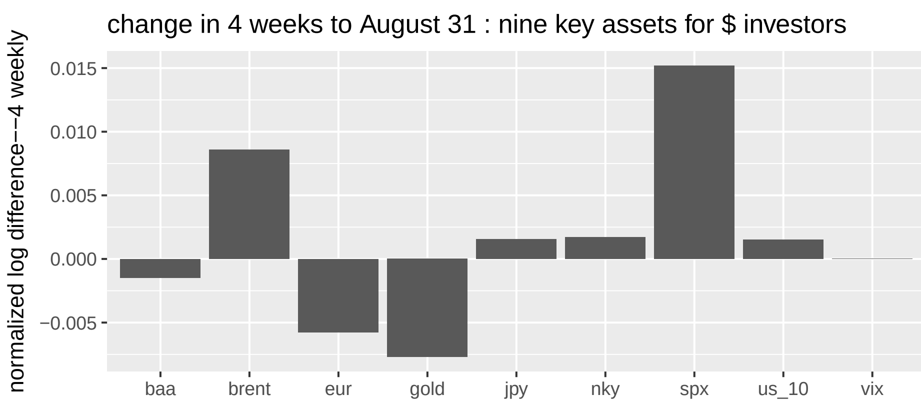
US equities broke upward, after half a year of stagnation, fueled by the apparent roll-back of some US tariff plans. US equity risk as represented by the VIX remained low. Japan's stocks were up, but Europe's were down.

Oil prices rose as falling production in Iran and Venezuela were reported. Copper fell with worries about China's growth, as did several agricultural commodities.

Most developed country bonds, both sovereign and corporate, were little changed as the risk of possible tariff disruption and EM weakness was balanced by stronger US growth and equity values.



What Markets Said A dollar-bond repayment panic has gripped emerging markets. Big currency swings can create lopsided pressures to borrow in super-cheap dollars when the dollar is falling and then to repay with suddenly scarce dollar as the dollar is rising, like now. Possibly as a relative safe-haven from the carnage elsewhere in emerging markets, Indian equities surged.

Meanwhile, the potential disruption to global growth from emerging market shocks and from the unpredictable harm from US tariff threats held back rate hike fears. Except in Italy, where a new government risks taking the country in the direction of emerging markets. We saw a sharp sell-off in Italian bonds and a related surge in funds going into the Swiss franc.

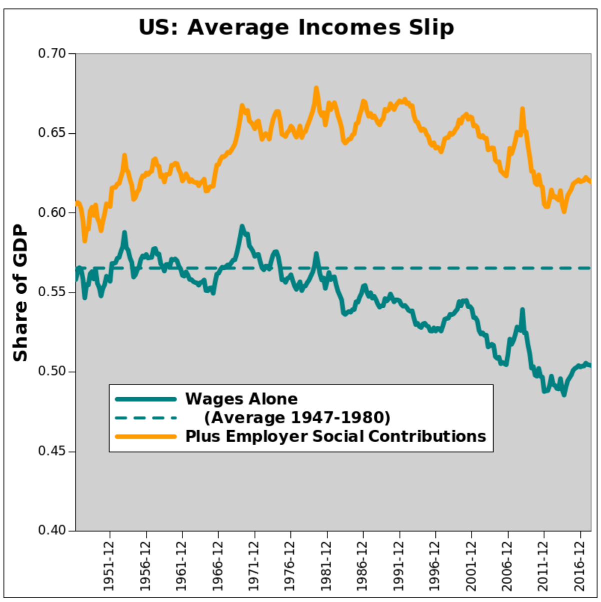
Meeting in the Mountains. Central bankers took a weekend away from the day to day, including market sentiment, to consider structural issues at Jackson Hole. Ten years into our recovery not all is going as foreseen, and central bankers asked: Why?

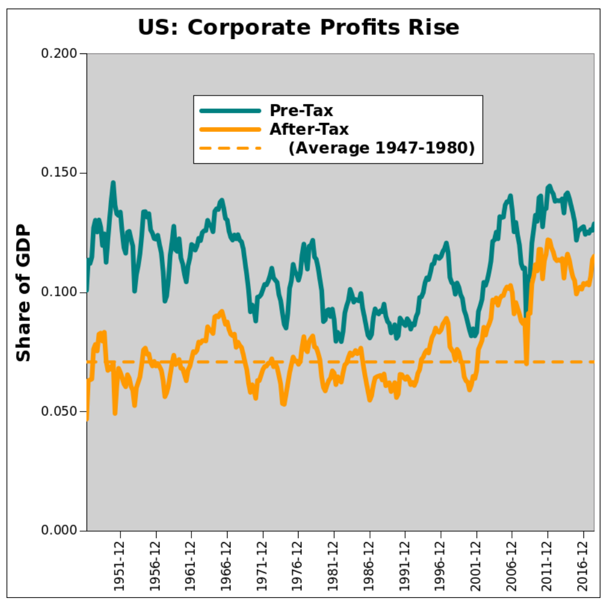
Unexpected behavior at this stage in the recovery include: rising profit shares in GDP, rising inequality in the division of the shrinking wage share, low corporate investment, and sticky and low inflation. Are these oddities somehow linked to some over-riding structural change? Academics responded to the question by looking for explanations, mostly in detailed micro-data for businesses, broadly agreeing that companies are becoming more concentrated in every product line.

Concentration might ominously arise from the collapse of anti-trust vigilance. We may have lost the broad principle that small companies are better from a political and social point of view, beyond any strict economic consideration. If so, companies may be covertly concentrating market power to raise prices, and reduce wages. Certainly that is a possibility, and it would conform to a system of slow growth where defending rents is more important than innovation and change. This worrisome explanation fits with the unusually low level of reported business investment, the scarcity of productivity gains, and the rising share of profits compared with wages.

Business concentration could also, and more happily, be the transient result of successful innovation by market leaders. By seeking global supply solutions, using information aggressively in ways tailored to their business, and developing excellence in business processes, some companies can do better than others, cut costs and take market share. This more constructive type of concentration means that the market leaders are just fastest in exploiting new possibilities that will be competed away in time as their innovations seep into general knowledge.

Whatever the cause of market concentration, there is no denying that concentration is linked to falling wages as a share of US GDP. And company after-tax profits have risen. (See charts below.) It is a situation about which average voters have rightly protested, bringing us to the unusual presidency of Mr. Trump.





If Innovation Drives Concentration... Innovation and concentration can create at least temporary monopoly power. For example, Amazon's specialized internet retail delivery leads to falling costs that becomes an enormous barrier to entry for others. Elsewhere, network efficiencies for leaders in popularizing the internet, like Facebook and others also create advantages to scale. Without effective competition, these companies can profit from both innovation and some measure of monopoly power.

But innovation was also found by some researchers to bring higher intangible capital investment. Intangibles include, besides computer code, processes for using the code, patents, and the advantages of good business reputation. If winning businesses are investing heavily in items like these, increasingly reported as current expense, that will lift the nation's effective investment rate, deflecting some concerns over unusually low reported investment in this recovery. It also suggests less harm of under-investment by techno-monopolists once they gain the protection of great scale.

For related reasons, information-intensive investment may not be as interest rate sensitive as it once was. Coding and business processes constantly build on the work of others, so the pace of communal change can be fast. Classically, interest rates were thought to influence time-bound decisions involving long lead times for heavy machinery or, in illustrative examples, waiting for wine to age. Without the long period over which interest rates can exert their greatest effect, central bank policy might have an weaker effect on investment spending. By itself, this could argue for bigger rate changes when needed.

Global logistics and business planning can sharply reduce costs, creating many avenues for specialization. Specialization promotes trade in intermediate products, each one of which can be dominated by a small number of excellent companies to be found anywhere in the world. Again, the first companies to take advantage of the possibilities do better, gain market share, and make unusual profits. Along the way we all collect the benefits of specialization that Adam Smith expected long ago.

That rising portion of innovative trade which crosses borders will bring additional changes. One will come via the increasing impact of exchange rate changes on local prices as imports grow as a share of total supply. In fact, some of the academic research at Jackson Hole did show a striking rise in the global explanation of national inflation rates, and diminished local explanation. If so, exaggerated but temporary swings in national inflation may follow exchange rates swings, clouding the visibility of underlying global inflation trends.

Consequences of Change. Assuming we are in the worrisome case, of monopolistic concentration, the best answer to inequality would be regulation of market leaders. That might be quite a shock to investors expecting continued unfettered monopoly profit for market leaders, some of them technology companies.

Alternatively, in the happier case of transient technological concentration, the best answer to inequality could be education and training of workers. People will simply need to move faster to keep up with changing qualifications in changing industries.

Sadly, none of these answers are likely from this administration. If you have a problem, do something. Yes. But the policies actually implemented, including a corporate tax cut, a substantial deficit into recovery, and several tariff proposals are ill-suited to meet the structural changes and challenges we have discussed, and are indeed instead likely to increase economic volatility.

For the purposes of central banking, a huge supply shock is underway for the world which has kept prices down. If so, the threat of tariff barriers could contrary-wise jolt up short-term inflation, and might also squelch investment planned for the specialized global economy. No wonder random threats to roll back global trade causes such alarm in financial markets. Who can say if inflation or recession, or both, are the most likely outcome of these misguided measures, if indeed they are actually put into place?

Lastly, Fed Chairman Powell came to Jackson Hole to comment on Fed policy amidst the issues we have outlined and others. Almost as a throw-away, he mentioned the really big elephant in the room. It seems, he said, that low interest rates have been helpful in driving down unemployment, but that signals of the need to ease up on the gas and raise rates today may come first in jumping asset prices, not in wages. Indeed so, assuming wrong-headed protectionist measures do not crash bubbling asset markets first. Among these and other uncertainties, I cannot see any solution for central banks but to raise rates cautiously.

Macro Surprises. China, with its high investment, is uniquely vulnerable to trade protection. Going into the year, long-awaited leveraging measures have already cut sharply into shadow credit. On top of this, uncertainty about the extent and impact of US trade sanctions will additionally get in the way of investment plans, which have already slipped. You can tell policy makers are worried because interest rate, exchange rate, and limited increase in local government credit has been invoked to limit the damage.

In Europe, expectations stabilized when Mr. Trump relented on some of his tariff threats, although not those aimed at the important German auto sector. At the same time, a downdraft in export orders was probably due to the end of a process of refilling global supply chains. But that export-led downdraft seems to have mostly passed, leaving a recovery based on home demand intact. Elsewhere, claims by the new Italian government for the highest fiscal deficits acceptable by Brussels, and the markets, is threatened. But, in the end, taking undue fiscal risks in an unsettled global bond market is probably too obviously dangerous even for Italy's novice politicians.

So far, US jobs advance steadily, bolstering earned income around mid-year, even if average wages are barely keeping up with inflation. As in Europe and Japan, however, these gains may slow with the completion of the inventory refilling cycle, even with the additional fiscal boost. Offsetting that fiscal push, home buying has paused in reaction to substantially higher mortgage rates. And, despite the great corporate tax cut experiment, investment could still be held up by the uncertainty about disruption of global supply chains.

Possibly reflecting a financial panic in emerging markets, global inflation pressures remain spotty. Fears of a China slow-down pulls down commodity prices, particularly metals. But oil prices remain high. With mixed commodity prices, the continued global expansion in developed nations, challenged but intact, seems to be gently pushing upward the underlying pace of inflation.

Among emerging markets, including China, a broader currency sell off has developed than I expected. Relatively new floating exchange rate regimes seem to be running into a type of systematic trouble, as advanced country interest rates hesitantly rise a little and emerging market currencies suddenly fall a great deal. What follows is a sudden jolt to the debt-carrying capacity of companies in emerging markets that have sold dollar bonds heavily into the policy-led global bond boom.

But this must be only the first act in larger play, as central banks finally react to inflation creeping up on their targets by starting to raise rates. It will be a test for all borrowers, in developed as in emerging markets. In the end, less cautious borrowers may find that they cannot pay when investors become more critical. The big question remains whether we go into a controlled process of risk aversion and loss in segments of the markets, one at a time. I have to assume so, and that the next target is going to to industrial country corporate bonds.