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The Rise of the Populists**: Article 2 of a series of articles on the global economic challenges impacting investors by Investment Strategist Peter Lucas.**

The last article in this series described the role that unorthodox monetary policies have played in widening income inequality and inflating market valuations. This article examines the first of these themes in greater depth and consider the role that it will play in the next phase of the story.

Income inequality has waxed and waned over time, playing out in long cycles lasting several decades. The last time that income inequality was at current levels was one hundred years ago in the "Roaring Twenties" after which time it started a long slide into the 1970s. It then bottomed with Reaganomics and Thatcherism and started the long climb to its current lofty levels. "Greed is good" as Gordon Gecko famously said. Well, good for some anyway.

Part of the reason for this cyclical pattern is the fact that, whilst income may be distributed unequally, votes are not. When things get sufficiently skewed, voters get angry and demand change. With inequality close to historic highs, it seemed reasonable to think that politics was about to get nasty, and so it has proved. Voters are frustrated and angry but are unsure who to blame. The UK has been an interesting case in point. In 2016 voters opted to leave the EU (essentially a right-wing agenda) and then almost put a Marxist into Number 10.

But this is not just about the UK. This is very much a global story. The election of Trump and the almost-success of Bernie Sanders in the United States were very much in the same vein. In fact, wherever you look we see politicians opportunistically tapping into this voter angst, usually championing policies that are easy to sell but are unlikely to deliver as advertised. This what populism is all about.

Clearly our brand of capitalism has flaws. After all, it facilitated this drift to extreme levels of inequality. However, it has also achieved much in terms of fostering technical innovation and raising living standards. To paraphrase Churchill, capitalism is the worst way to allocate resources, except for all the others. The populists will gleefully smash all that is good about capitalism in their drive to fix that which is bad. Take globalisation, which has been a key factor behind the low growth, steady growth environment of the past 40 years. That is now very much under threat.

To get a sense of where this could lead, we need only look back to the 70s, when capitalism was similarly mistrusted, and the Cold War meant that many countries did not talk to each other, let alone trade. This was the era of stagflation – low economic growth combined with high inflation – the worst environment for bonds and (most) equities. As we will examine in the next article, the current high level of market valuations and stagflation would not make happy bedfellows.

But before you immediately go out and sell everything, consider this: the current preoccupation of markets and investors is deflation not inflation. Indeed, most consider the prospect of inflation to be either distant or, following the lead of Japan, non-existent. The likelihood is that any signs of inflation will initially be greeted with relief, like a long-lost friend – a green flag indicating that the risk of deflation is receding. It is only when inflation becomes more of a deep-seated problem that equity markets might have a problem. Or to put it another way, you cannot go from deflation to inflation, without crossing through a long phase of Goldilocks ("not too hot, not too cold, but just right"). And equity markets like Goldilocks.

It took years to get to this extreme level of inequality and things are not going to get sorted overnight. So, like it or not, populism is probably here to stay, or at least until things get so bad that sense prevails. As worrying as that might sound, populism could prove to be good news for the markets at least for a while. Having tried austerity, which was very unpopular and did not really achieve anything, governments were itching to shake the magic money tree and now COVID-19 has given them the perfect cover to do just that. The populists are not going to solve our many economic problems, but one suspects that they are going to have a lot of fun trying.

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