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"Back in Synch"

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The Olympic motto ("Swifter, Faster, Stronger") captures the essence of competition; that through competition the best is brought out in all participants. For those in the investment field, competition is an ingrained part of our understanding of how markets operate. But regardless of whether thinking in terms of athletic competition or markets, true competition can never be assumed.

Although not an Olympic year, recent news about Los Angeles possibly hosting the 2024 summer games brought back memories of the 1984 games also held in that city. The 1984 games were a huge success, considered the most economically successful Olympics to date. Americans watched in droves as U.S. athletes racked up an impressive, games-leading 83 gold medals and 174 medals in total. U.S. track star, Carl Lewis, tied Jesse Owens' 1936 Olympic record by winning four gold medals in track and field.

And still, while the games were a tremendous success for the U.S., this was largely thanks to the Soviet-led boycott. The boycott meant that Russian gymnasts, East German swimmers, Cuban boxers and other Soviet bloc athletes didn't attend. Through no fault of their own, U.S. athletes benefited handsomely from the pared down competition. Just ask McDonald's how the boycott impacted the games' outcomes.

In terms of investments and economics, competition is considered necessary if markets are to function properly. Through a competitive marketplace winners and losers are borne out. The negative outcomes from competition are outweighed by the positive ones, or so we are told. Indeed, in the past, displaced workers historically did find new opportunities. Investment in the new economy overcompensated for the losses in the old economy. Capital is redirected to the prospect of higher returns. While there are winners and losers, the net benefit is expected to be positive.

Yet, the notions that competition can be hindered and markets imperfect have been with us for some time. In 1890, the U.S. Congress passed the Sherman Act for the purposes of protecting and ensuring competition. As the U.S. Supreme Court recently explained, "The purpose of the [Sherman] Act is not to protect businesses from the working of the market; it is to protect the public from the failure of the market. The law directs itself not against conduct which is competitive, even severely so, but against conduct which unfairly tends to destroy competition itself" (*Spectrum Sports, Inc. v. McQuillan*, 506 U.S. 447 (1993)). Additional legislation was passed to limit the use of consolidation and mergers and acquisitions from reducing competition. It was recognized that as the winners gain scale it is difficult to compete. In 1936, the same year that Jesse Owens obliterated his Olympic competition in Berlin, Congress passed the Robinson-Patman making it illegal to use price discrimination practices to drive away competition.

Accordingly, one cannot assume perfect competition – timing and context matter. The Soviet boycott didn't shorten the distances ran or swam, but it certainly impacted the quality of the competition. In the economy, the tradeoff between risk and reward is dependent on the timing of the change, as well as, the ability of the existing economic system to accommodate the volatility. The scale and pace of change today rivals other transformative periods in history. The industrial revolution transformed a rural, agricultural society into an urban lifestyle focused on manufacturing. The assembly line lured workers from the farm to the rewards of a mechanized existence. The farm adjusted to the loss of labor through investing in capital and machinery. Overall, for the farm and the factory, productivity expanded and standards of living improved.

Rapid change is upon us once again. Sensors, robots, machine learning and artificial intelligence are some examples of innovation designed to replace humans rather than substitute them for different activities. It was Joseph Schumpeter who characterized the notion of creative destruction. He wrote, "The gale of creative destruction describes the process of industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating the new one."[i] In this regard, Schumpeter shared with Karl Marx a common belief that capitalism would rise, but also fall under its own weight. So far, seeds of destruction haven't germinated. The new has been an improvement over the old.

Key players in the current economic context are the central banks, particularly those in developed countries, who are gradually converging on policies designed to withdraw the unprecedented levels of accommodation provided to financial markets since the crisis. The central planners have been out of synch and out of sorts since the U.S. Federal Reserve began its path to normalize interest rates in 2015. Their success in removing stimulus will require all the teamwork and flexibility of a gold medal effort. And, like the synchronized swimmers, who competed for medals for the first time in the 1984 LA games, central bankers must execute their maneuver while avoiding hitting the bottom. A less than graceful exit from their unconventional policies could precipitate the next crisis.

While showing signs of strength, the global economy isn't in the clear, yet. Fortunately, the often predicted hard-landing in China has yet to materialize. So too, Brexit appears to be moving forward absent the catastrophic economic calamity which many thought inevitable. Europe is on the mend, having kicked many a can down the road. Even emerging markets are showing signs of animal spirits. The renewed confidence presents the perfect time for policy makers to act. However, they must be careful not to upset this fledgling economy.

Global growth continues to lag prior cyclical recoveries and inflation has proven stubbornly difficult to promote. Ironically, it is the fear of not having enough flexibility to respond in the event of a future recession, that is motivating policy makers to move to tighter monetary conditions. It is a delicate balance indeed, to restrict credit risk from becoming excessive while attempting to not cause the next downturn. Cyclical inflation pressures may be building but the threat of secular deflation remains.

At the same time, the population of the developed world is shrinking and aging more rapidly in relation to the developing world. Globally, the wealth disparity between rich and poor is expanding while the knowledge gap is shrinking. Technology threatens to be the great equalizer. Information is making the world smaller not larger. Disruptive technology may be the source of innovation but it is also a threat to the existing order. What all this means for global competitiveness, will it be generally positive or negative, and for who, is still to be seen.

Nevertheless, an unintended consequences of reckless central bank policy very well may be to drive away competition. Easy, available credit increases the advantages of larger players. Economies of scale allow companies like Amazon to offer subsidies to consumers through distribution methods that are impossible to replicate. Uber can provide a great consumer service at a reduced price through a business model designed to lose $80 million a year. Investment house BlackRock offers index products for pennies on the dollar because the marginal cost to their business of adding new clients is approaching zero.

Over the short run, in the battle over market share, monopolistic models can benefit consumers. Ultimately, however, the concentration of market share leads to pricing power and an uncompetitive marketplace. Don't be surprised that as central banks start to coordinate more restrictive policies, governments will focus more attention on predatory pricing as an excuse for slower growth, deflation, and credit risk.

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[i] Schumpeter, Joseph A. (1994) [1942]. *Capitalism, Socialism and Democracy*. London: Routledge. pp. 82–83.