CLOUGH CAPITAL
THE MACRO COMPASS

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The Case for Lower Interest Rates

In a world teetering on the edge of economic uncertainty, a surprising beacon of optimism emerges for equity markets.

Despite recent concerns and market volatility, we think a closer examination of key economic indicators and long-term trends reveals a landscape ripe with bullish potential, particularly for equities.

The global economy continues to exhibit disinflationary tendencies, with most measures of inflation expected to decline further. This trend is supported by several factors, including the potential impact of tariffs, which historically have often proven deflationary due to retaliatory measures and consumer substitution behaviors. Interestingly, despite aggressive monetary tightening by the U.S. Federal Reserve (the "Fed"), with a 500 basis point[1] increase in Fed Funds and an 18% reduction in its balance sheet from early 2022 to the middle of 2023, equities have shown remarkable resilience, suggesting alternative sources of liquidity beyond central bank interventions.

Contrary to popular belief, the market may not be as overvalued as commonly perceived. Recent data from Empirical Research Partners LLC highlights the S&P 500 Index's[2] impressive return on equity ("ROE") of 20% in 2024, with the most recent quarter boasting an even higher 24% ROE. Assuming a 75% payout through dividends and stock buybacks, the market's internal rate of return stands at a robust 15%. This performance is underpinned by long-term deflationary trends that have persisted for decades, driven by demographic shifts, technological advancements, and evolving consumer behaviors.

Demographics play a crucial role in shaping the yield curve, as an aging population tends to save more, particularly in retirement. This phenomenon, exemplified by Japan, contributes to reduced consumer spending on big-ticket items and increased savings rates. Simultaneously, the private sector's high leverage, at 145% of gross domestic product ("GDP"), makes servicing debt at high nominal interest rates increasingly challenging, putting downward pressure on money rates.

Technological advancements, especially in artificial intelligence, appear to be driving significant productivity gains. Despite a 1-2% decrease in hours worked compared to several years ago, real GDP has surged 6-8% higher, highlighting the profound impact of technology on economic output. This efficiency boost, coupled with ample domestic liquidity and continued government spending, we believe creates a unique economic environment where traditional indicators may not fully capture the market's potential.

In conclusion, while challenges and uncertainties persist, the underlying economic fundamentals paint a picture of resilience and potential growth for equity markets. The confluence of disinflationary pressures, technological advancements, and demographic shifts suggests that the current market dynamics may be more sustainable than initially perceived. As we navigate through these complex economic waters, investors who can look beyond short-term volatility may find themselves well-positioned to capitalize on the long-term bullish trends shaping the global economy.

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[1]A basis point is a unit of measure used to describe changes in interest rates. One basis point is equal to 1/100th of a percentage point.
[2]The S&P 500 Index is a diversified, market-capitalization weighted index which measures the performance of 500 of the largest U.S. equities representing all major industries.
Information for each listed index is for illustrative purposes only. Indexes are unmanaged and an investor cannot invest directly in an index.

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