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Central banks scrutinise the impact of 'superstar' firms

While financial pundits were fixated upon the dovishness/hawkishness of major central banks, we perceived this year's Jackson Hole symposium as something rather different: a "summer camp" of top economists playing catch up with a new reality.

The global central bank collective is grappling with a set of anomalies that question the relevancy of traditional economic models. Why, when unemployment is at very low levels, has wage growth failed to pick up? Why are we seeing feeble productivity gains and weak physical investment despite high profitability? And why has it taken so long to coax stubbornly low inflation up towards target? At the annual Jackson Hole central bank summit last week, economic luminaries were deployed to delve into the these phenomena. 'Superstar firms' - the shrinking number of mega-firms are which have harnessed globalisation and technology in order to become the most dominant firms in their industry – are emerging as the culprit.

In his book, *The Four,* Scott Galloway describes the algorithms of Amazon, Google and Facebook as the most valuable man-made things ever created. Yet algorithms, and other types of

intangible capital require very little initial investment and at the same time are highly scalable which has allowed select firms to grow exponentially. At the symposium, Nicolas Crouzet from Kellogg School of Management purported that 'intangible capital' has caused a rise in industry concentration by a few players. For example, one measure of corporate concentration, the Herfindahl-Hirschman index, is up 48% since 1996. In turn, noted the Kansas City Fed who hosted the event, this may be diluting dynamism, productivity growth and capital investment. Physical investment has been very low, relative to corporate valuations, since the late 2000s

Central bankers also face a puzzle when it comes to wages. In the past decade, despite rising profits, labour's share of income generated has declined in the US and in other countries. Even now, with US unemployment below 4%, when employers should be competing to attract talent, wage growth has been tepid. At Jackson Hole, Princeton economist, Alan Krueger, presented a paper entitled 'Reflections on Dwindling Worker Bargaining Power and Monetary Policy'. He floated the idea that perhaps weak wage growth is the result of a "monopsony" whereby the market place is dominated by a few major employers, giving workers less leeway when it comes to demanding higher pay. These large firms may even be able to inadvertently collude to limit pay levels. Of course, in many cases, algorithms and other forms of intangible capital represent a structural shift in that there is overall less demand for labourers.

Inflation's elusiveness has also perplexed the world's major central banks. Harvard economist Alberto Cavallo noted the "Amazon Effect" whereby rapidly adapting pricing algorithms used by the online retailer and its rivals are skewing inflation. He found that the shift has led to a greater influence of movements in the US dollar exchange rate and gas prices on retail prices. Inflation is a key gauge that central banks use when setting monetary policy and so it becomes essential that these new inflationary dynamics are somehow conceptualised.

Undoubtedly the rise of superstar firms has caused increased market concentration, perhaps altering the very workings of our economy. For central banks, it seems that the Jackson Hole event was only the first twist in understanding this complex new Rubik's cube in which many micro elements converge with the traditional macro drivers of the economy. For now, a key take away may be that this time it really is different and the business cycle could extend much longer than it has in the past. This parallels with our base case which does not foresee imminent overheating in the US economy, compelling us to maintain an equity overweight in the US.

However, over the longer run, we expect that central banks and regulators may begin to consider implementing policies that more effectively redistribute the wealth of superstar firms and dilute their influence. This would potentially mean re-designing competition rules and policies on items such as mergers and acquisitions – especially in sectors such as Technology which is home to many of the new breed of 'superstar firms'. If status quo ensues, and the gap between tech capital and human capital grows wider, it isn't unrealistic to assume that 'Occupy

Silicon Valley' could become the next 'Occupy Wall Street' as people grow frustrated by the power and share of the economy that only a handful of firms possess. As a prime example, after it become the first US listed company to reach $1 trillion in market cap, there were only 16 countries with a GDP equal to or greater than Apple's valuation, according to World Bank data.

That said, in the near term, we remain positive on the Tech sector as it remains to be highly profitable. It seems that the central banks will need some time (and perhaps a few more 'summer camps') to understand and model this 'new normal' before any regulation comes to fruition.

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