THINK-TANK 2023 ROUND-UP

The good news is that the era of la-la land monetary policy, that long period of zero or negative interest rates and money printing on a biblical scale, is over, hopefully forever. As Kallum of Berenberg said, 'the new normal is over'. The bad news is that the process of normalising, correcting the huge imbalances built up – mis-allocation of capital, excessive debt, and ultimately a great surge in inflation – is proving to be painful, and it hasn't yet reached its end. Kallum sees shorter, more volatile cycles ahead, inflation a longer run concern, and higher 'normal' interest rates, a prospect that I think has a reasonably high probability of playing out.

Multi-asset funds have been particularly badly hit, with their usual diversification benefits not rewarded. But I can tell you with confidence that we are much closer to the end than the beginning, and the opportunities that have opened up for multi-asset funds are as good as they have been for a long time. More of that later.

Since our last Think-Tank, the Fed Funds rate has gone up by 300bps, and US bond yields by around 100bps in longer maturities, almost 200bps in shorter ones. We've been through a banking crisis, geopolitical upheavals and an unexpected downturn in China. Yet global equities are up by over 25% from the low in October last year, and the US economy continues to confound analysts, with growth consistently surprising on the upside. Is it possible that the Fed can engineer a soft landing, or are equity markets complacent, disconnected from reality, and riding for a fall?

First, some perspective: the equity market has been unusually narrow this year, dominated by mega-cap tech stocks in the US. The top 10 stocks are up by 60%, whereas large parts of the market have made little progress. Outside the US, Japan has been strong, but China is down and other markets in Asia have struggled, as has the UK, while alternative assets such as property, infrastructure, commodities and hedge funds have made little or no headway. This feels much more like a bear market than the bull market that, at least technically, we are in.

The US has become more pivotal than ever; it makes up 70% of the global developed world market capitalisation, it's the only full-spectrum superpower, self-sufficient and extraordinarily resilient, is a global leader across a swathe of industries and services, and there is nothing to challenge the supremacy of the dollar. As Larry Summers, former Treasury Secretary, said when dismissing the notion of a rival to the dollar, 'Europe's a museum, Japan's a nursing home, China's a jail'; a rather superficial assessment but I agree with the sentiment. There is no rival to the dollar, and the BRICS countries won't conjure one up any time soon, they have no centralised institutions or standards, no monetary convergence, no backing, and it would be dominated by China.

How this cycle will evolve rests with the US. The peak of the rate tightening cycle is in sight, but the Fed is still reducing liquidity at an annualised rate of over $1tn, and all the signals from Powell point to a continuing tightening bias until inflation is moving sustainably down to target, keeping the door open to a further hike in rates and holding rates at restrictive levels for an extended period.

For much of the past year markets have been adjusting to this tough narrative and have progressively pushed out expectations for rate cuts until well into 2024. The longer policy stays tight, the greater the risks of a financial accident or recession.

The easiest part of the job to control inflation is over, the more challenging and uncertain part lies ahead. As supply chains normalised, energy markets stabilised, excess Covid-era savings expended, and borrowing costs pushed higher, a big fall in headline inflation was inevitable. The question now is how much longer rates will need to be kept at restrictive levels to bring core inflation to target. Recent evidence is that this will take some time. Wages are rising at well above the rate of inflation, increasing the risk of inflation becoming embedded. The labour market is tight, with unemployment near record lows and job vacancies far above the numbers unemployed - an important factor in the resilience of the economy, supporting retail sales and consumer confidence. Pro-cyclical fiscal policy also provides a tailwind, with Biden's three big economic nationalism acts beginning to have an impact in stimulating capital expenditure, funding infrastructure investment, semiconductor production, and clean energy, with combined outlays of up to $1.2tn along with open-ended tax credits. The recent rise in the oil price is also unhelpful to the disinflationary cause.

There are some tentative signs of softness emerging, raising hopes of a soft landing: surveys suggest consumer confidence is tailing off, latest data on the jobs market show vacancies falling and fewer new jobs created, a rise in the unemployment rate and an increase in the labour force participation rate, while leading economic indicators point to tougher conditions ahead.

But the Fed has shifted from forward guidance on rates to become data dependent, and will need to see much more evidence of a sustained fall in core inflation before easing; uncertainty for investors will be heightened, with markets likely to be buffeted by data releases.

The one certainty is that the Fed is intent on finishing the job, even if that triggers higher levels of unemployment and a sharp slowdown in the economy.

The second big issue is China. After a brief post-Covid spending surge early in the year, China's structural problems overwhelmed its recovery and the economy is suffering a sharp slowdown, leading to a selloff in the equity market, down 20% from the peak in January, and 50% below its all-time high in early 2021. The authorities are being tested, the longer-term growth rate is in doubt, and there are worries that China's woes will spill over to the rest of the world.

Uppermost is the huge but highly leveraged property development industry, which accounts for over a quarter of China's economy. House prices and real estate investment are in a prolonged decline; as Adrian of Ashmore told us, many developers are in or close to default on their debt, and contagion risk is spreading to local governments. These have relied heavily on land sales, now dried up, to fund their spending and are indirectly exposed to default risk via their funding arms, local government financing vehicles, created to finance infrastructure and real estate developments, vital to China's growth. But much of the investment is unproductive with returns that don't cover debt servicing. The IMF estimates that LGFVs have debts of $9tn, property developers a further $5tn.

But excessive debt is not restricted to property. Corporate debt as a percentage of GDP is almost three-times that of the US, UK and Germany, about the same size as the US Treasury market. Three-quarters of it is held by State Owned Enterprises, where the problem is compounded by weak productivity and a slowing economy. Bank lending has fallen sharply in recent months; increased non-performing loans and further defaults seem inevitable.

Aside from problems with debt, and the challenges of rebalancing its economy away from investment and exports to consumption, China is grappling with US-imposed constraints on technology imports, de-globalisation and re-shoring of supply chains away from China – de-Chinafication, Mark Baribeau of Jennison called it - as well as the longer-term structural challenge of a rapidly ageing population, falling fertility and declining workforce. The working age population has been in decline since 2015, and by mid-century there are likely to be over 200m fewer workers, a fall of almost 25%, and the total population is also now in decline.

China will remain a huge economy but those forecasting that it would soon overtake the US will be wrong: GDP per capita is still only one sixth of that in the US; China risks getting old before it gets rich, and it will be a very long time, if ever, before it becomes a bigger economy than the US.

But it is important to recognise that the debt problem is very unlikely to be systemic; the majority of bad debts are held by SOEs and local government financing vehicles, and most of the banking system is state-owned. There is relatively little foreign currency debt, external debt amounts to $2.6tn or 14% of GDP, more than matched by its FX reserves of over $3tn.

The State can manage the timing and pace of recognition of non-performing loans, and ensure banks remain liquid. High debt limits the government's options for fiscal stimulus, hence the piecemeal easing measures taken to date, and constrains growth, but is essentially a domestic problem with very limited contagion risks globally.

Some commentators believe that China's domestic problems will lead to a more aggressive foreign policy, with fears of an invasion of Taiwan before it's too late. It's not a zero risk but seems very unlikely given the huge risks and costs entailed, and the impact on China's standing in the world. China takes the long view, and I suspect will continue to be patient in fulfilling its aim of Taiwanese reintegration.

Many have also taken the view that China has become uninvestable. That is not one that we share. We recognise the risks, the structural challenges, the inexorable long-term decline in the growth rate, and the unwelcome tightened grip on power exercised by President Xi. But China has the wherewithal to work through its debt problem and it will continue to be a major manufacturing centre, a massive consumer market, and home to a wide range of very good companies in the private sector, now selling on much lower valuations. Adrian of Ashmore described the dislocation in China's high yield debt as the biggest opportunity in his 20-year career. We see good opportunities for recovery and longer-term growth in China, but it is important to reflect the risks in appropriate position sizing in portfolios.

India has just overtaken China to become the world's largest country by population and is a favourite of emerging market investors. It is growing rapidly and offers good long-term prospects, but is a much smaller economy than China, about one-fifth of its size, and is already a very highly rated market. It is by no means a hidden gem.

India's rise and China's woes shine a spotlight on geopolitics. In many ways the carefully worded communique from the latest G20 meeting, held for the first time in India, with the section on the war in Ukraine making no mention of Russia's involvement, reflects the shifting power-play globally, and the growing importance of the developing world in international relations.

Given the close ties between Russia, China and India, resolution of the Ukraine war, an attritional war with no decisive shift in the battlefield balance in sight, will require their diplomatic involvement. Whatever the resolution, it's impossible to see Russia's relationship with the West returning to its pre-war status. That means Europe will have to live without the cheap Russian fossil fuel supplies on which much of its industry depended, and as a result with permanently higher power prices.

Most exposed to these headwinds is Germany. The German economy is the biggest in Europe, accounting for a quarter of the EU's GDP, and its most influential member. It is facing a storm.

Its heavy dependence on Russian gas and a huge manufacturing sector whose biggest trading partner is China, are major headwinds. Inflation is still over 6%, industrial production has fallen in four of the last five months, and the economy has endured three consecutive quarters of negative or zero growth with leading indicators pointing to further pain ahead. The ECB has just revised down its forecasts for growth in the Euro Area this year and next, and even these look optimistic.

While some of Germany's and Europe's problems are cyclical or result from exogenous shocks, others are structural, such as ageing and declining populations, or are deep-seated constraints to growth like inflated public sectors, over-arching levels of bureaucracy, the precautionary principle approach to policy-making, and the huge and ever-rising burden of regulation, leading to pervasive risk-aversion.

It was perhaps reassuring to hear German Chancellor Scholz recently calling for a nationwide pact to reinvigorate the economy and overcome 'the mildew of red tape, risk averseness and despondency' that has weighed down the economy, but given that came from the leader of a centre-left political party that has been in coalition government for much of the period since the EU was formed, I suspect that change, if it comes, will be glacial.

Typical of the constraints holding back growth, the recent EU Green Deal, designed to match the Inflation Reduction Act in the US to attract investment in clean energy, is full of ambitious targets and aspirations but very little new funding or concrete spending initiatives.

There is no fiscal union so member states have to provide the funding, but member states are constrained by EU fiscal rules, have little or no appetite for joint debt, and are increasingly pushing back on net zero targets in the face of rising political and popular dissent. The only actual new funding appears to be about EUR50bn, not enough to move the dial, and accompanied by restrictions, prescriptive regulations, and unrealistic targets. Even the most pro-EU leader, France's Macron, has called for a European regulatory pause on environmental standards to protect competitiveness.

Regrettably, the UK has been moving in the same direction, with weak levels of productivity embedded in its bloated public sector, a tax burden at the highest since WWII, a growing burden of regulations holding back enterprise, a workforce inactivity level of 21% that is struggling to return to pre-pandemic levels, and a government that has been inept and ineffective.

The spectre of stagflation has reappeared across Europe, a region which is destined to continue its sluggish growth rates of the past decade, persistently underperforming the US. However, as Dan O'Keefe of Artisan explained, that does not mean there are no opportunities in European or UK stock markets. There are healthy, world-class companies across a range of industries and services, many trading on discounted valuations based more on macro concerns than their prospects.

Nowhere is this more evident than in the UK, where the market has become deeply unfashionable, and is offering some outstanding valuation opportunities. Gauging when those opportunities are realised is difficult, but realised they will be – if not by investors, then by corporate buyers, much as we are seeing with the flow of money coming into the UK from US companies and private equity.

A perfect example of the discovery and realisation of outstanding value in a country facing deep structural problems is playing out in Japan, a market that has been off the radar screen for investors for most of the past 20 years. Reforms in the corporate sector focusing on shareholder returns are bearing fruit - Sophia of FSSA Investment Managers gave us some compelling examples - and Japanese equities have led the way this year with a return of 25%. We are confident there is more to come.

Valuations matter, and even in a tough environment as now, there are always opportunities in equity markets, somewhere, in some sectors and some style factors. Periods of weakness present the chance to accumulate those assets. The biggest and most important valuation change however, and resulting opportunity, is not in equities but in government bonds.

For most of the post-GFC period, safe haven bonds were ridiculously over-priced, and we avoided them. Negative real yields and in many cases negative nominal yields made no sense, largely eliminating their traditional role in multi-asset portfolios. Today, yields are back to levels not seen since before the GFC and are offering attractive nominal and real yields, the first time we have been able to say that for many years.

The process of yields normalising meant that 2022 was one of the worst years ever for global government bonds, and was a major reason for multi-asset portfolios' poor returns. All parts of the fixed income universe came under pressure and alternative income assets were hit as the discount rate used to value those assets moved sharply higher.

We have seen a similar trend this year as bond yields have continued to push higher; although much better than in 2022, bond returns have again been negative, while alternative income assets have been especially weak as the duration of the period of high rates takes its toll. But, as Alex explained, this huge change in valuations means safe-haven government bonds can return to their role as portfolio diversifiers, generating reliable income in real terms, alongside truly defensive characteristics, protecting capital in a way other assets cannot.

The latter stages of this monetary cycle will coincide with the Presidential election campaign in the US. Usually this wouldn't be of concern to investors; markets might move a bit in either direction around election time, but any lasting impact is exceptional. As things stand, the contest will be between one whose mental faculties are plainly in decline and another who is known to be a fruit cake. The state of the political divide was a big reason for Dan O'Keefe telling us that the US is in the worst absolute condition since the Civil War, a sobering thought, especially with geopolitical risks the most serious since WWII.

I suspect that most of us are hoping that the Democrats will persuade Biden to stand aside, and that Trump will be in jail, or the Republicans will force him out of the contest, but if not, the election could have a significant impact on markets. It's too far ahead to be making a call, a lot can happen in 15 months, but some volatility in the final quarter next year is in prospect. One thing we are confident about is that there will be few concessions to China ahead of the election: the tough line adopted by Biden has bi-partisan support and we will have to wait until the new President is in place to see how this most vital of relationships will develop.

The UK also faces an election next year. The choice is almost as dire as in the US, but for different reasons. We have an uninspiring and uncharismatic Prime Minister, Sunak, and the even less charismatic and uninspiring Starmer, neither of whom has a vision for the UK, or if they have, they have failed to communicate it. Starmer will almost certainly win by default, given the mess the Tories have made of most things, and the sense that it's time for change.

But it won't be a market moving event. Starmer has placed his tanks on the middle ground, which is where elections are always won or lost, so it will be more of the same, just with an even bigger State, higher public spending and yet higher taxes, ending in tears, as all Labour governments in my lifetime have left behind.

The UK has been at the forefront of the dash to net zero, but is reaching something of a tipping point; the popular acceptance of the need to go green has met the brick wall of the reality of the costs. Should there have been any credibility in the idea that a net zero world would be net costless has been firmly dispelled by the costs of transition now in full view, as expertly explained by Dan O'Keefe.

He presented a powerful case that challenges the received wisdom of the costs and benefits of the climate transition; he expects it to be inflationary and damaging to economic activity. I agree. Across the world, the debate is turning to the pace at which we make the transition and who pays, taxpayers now, or future generations. To what extent are current taxpayers prepared to accept a drop in living standards to provide future generations with the promised (but not guaranteed) more sustainable future? The answer increasingly seems to be 'please make me virtuous, but not yet', and government policy-making of the last 20 years would suggest that the can will be kicked down the road.

China, incidentally, relies on coal for 44% of its power, burning more coal than five years ago, and has enough coal fired capacity under construction to provide power for half of the UK. As Dan said, whatever we do here in the UK won't make a jot of difference to global emissions.

Combine that with the hypocrisy of ruling out the use of fossil fuels domestically but happily importing goods produced elsewhere using fossil fuels, effectively outsourcing carbon emissions to China and others, along with plenty of evidence of greenwashing, and the ESG movement has hit a tricky period.

And not just in matters of climate change. Recently the UK defence secretary called out ESG investors for undermining Britain's vital defence sector by blocking access to capital, not especially wise given the state of geopolitics. And the blizzard of bureaucratic box-ticking, coercive regulations and unrealistic targets is meeting resistance and undermining aspects of ESG.

ESG investing, of course, goes well beyond climate change, encompassing a much broader assessment of responsibility, sustainability, and ethical issues, across all stakeholders and society generally. Notwithstanding the concerns, we are certain the ESG movement is irreversible; companies that fall behind will pay a price in terms of competitive positioning and valuation. Lisa of Prusik illustrated the wide range of opportunities for extending the reach of ESG in Asia, and the importance of applying the principles in Asia, especially around matters of governance.

We fully embrace ESG principles; we have our own funds which invest according to strict sustainability factors and in full compliance with EU standards, and we embed ESG best practices across our process.

But this is a fast developing part of our industry and increased scrutiny and interpretation of the principles seems inevitable.

The other irreversible shift underway, which we are embracing with help from our partners, MDOTM, is AI - according to Bill Gates, the most important development since the PC.

It has the potential to enhance processes and generate a productivity boom, but unlike the industrial revolution, this time it will be office workers whose jobs will be displaced. MDOTM and Robeco showed how AI will be used in our own industry. We'll all soon be white collar Luddites!

Some see it as an existential threat, with catastrophic unintended consequences, and clearly regulations are on their way, but I see it more as a great enhancement to what we do, a transformational movement that is happening at breakneck speed which I doubt can be slowed. Mark of Jennison referred to the AI era as the 4th and biggest age of computing, and made a good case that AI leadership is not excessively valued. Its reach is reflected in the way it has rapidly become entangled in great power politics, and is part of the decoupling in the past year between China and the US.

The ultimate key to market direction is the battle to control inflation. Central banks everywhere are committed to finishing the job, and while interest rates are at or very close to the peak, they will stay there for some time, in restrictive territory through much if not all of next year. Monetary policy is now more data dependent, making it inherently less predictable than during the zero interest rates and forward guidance era. Inflation is difficult to predict, introducing greater uncertainty to the path of interest rates and duration of the cycle.

Furthermore, longer term structural changes - the energy transition, deglobalisation and reshoring, security of supply, higher defence spending – all incur big investment costs and are likely to be inflationary, making the job of central banks more difficult. Huge US Treasury issuance ahead also seems structural, with fiscal deficits projected to be 6-7% of GDP for years ahead, surely inflationary.

Investors will demand a higher term premium on longer duration bonds, a process that is well underway but probably has further to go.

The biggest risk is policy overkill; as Jeremy of CIBC said, 'policy-makers are prone to over-shooting'. Given the long lags for monetary policy to take effect, central banks have a tough balancing act. To reach an inflation target of 2% on a sustained basis and firmly anchor inflation expectations could well require the economy to be fully deflated, triggering higher unemployment and recession. Europe and the UK face bigger challenges and recession seems unavoidable; the US is better placed but it would be an extraordinary cycle if the Fed were to engineer a soft landing. Global manufacturing is already in recession, and leading indicators of activity suggest that it is highly unlikely that recession will be avoided more widely.

This is a challenging environment for much of the corporate sector, and the uncertainty is likely to be a headwind for equity markets. But we enter this tough period with households, companies and banks generally in good shape, with strong balance sheets, labour markets still tight, and the capex cycle supportive. Any recession is likely to be mild, systemic risks are very low, and contagion from China minimal.

The immediate outlook calls for caution, but this is not a time to be reducing risk, rather seeking out opportunities to add it. Away from mega-cap tech, valuations have drifted down this year and are offering good long-term entry levels. Government bonds are now firmly in attractive valuation territory, and would be the biggest beneficiaries of a recession or financial mishap.

The next major move in interest rates will be down, and although that will not be until next year, markets will begin to discount cuts in advance. We are increasing exposure to safe-haven government bonds, especially in short maturities, a part of the market which Tatjana of Muzinich eloquently explained is the most attractively priced part of the curve due to the steeply inverted yield curve. With yields on short maturity Treasuries of over 5%, we are being paid well while buying time before adding to risk assets, remaining alert to market setbacks to provide good entry points.

This seems to be an environment almost designed for multi-asset portfolios. They have fallen out of favour at a time when returns have been generated largely by an extremely narrow range of stocks, and when diversification has not paid off. With the historic shift in valuations of safe-haven assets over the past 18 months, multi-asset funds can again provide investors with true diversification, blending high income risk-free assets with attractive valuation opportunities across a very broad range of assets – almost certainly the broadest ever available, as Alex described yesterday, with especially good values in closed end funds investing in alternative assets, where historically wide discounts to NAV have opened up.

Diversification remains the surest means of constructing optimal portfolios for a full range of risk-return profiles; the major headwinds of the past several years, which damaged the diversification characteristics and undermined returns of multi-asset funds have abated, creating exceptional opportunities for medium to longer term investors. Now is the time to stay the course, to reap the rewards that lie ahead as we navigate this truly challenging cycle.

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