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Near-term risks still elevated

Around the table | LGT Crestone Investment Forum

October 2022

Our panellists

Mick Dillon
Portfolio Manager
Brown Advisory

Mick is a Partner at Brown Advisory and a portfolio manager within the global equity team based in the firm's London office. He joined Brown Advisory in 2014 from HSBC Global Asset Management in Hong Kong where he was the co-head of Asian equities.

Katie Petering
Head of Product Strategy
BlackRock Australia

Katie leads the product strategy for BlackRock Australia's range of multi-asset portfolios, including diversified asset allocation strategies, model portfolios, and multi-strategy hedge funds.

Alex Joiner
Chief Economist
IFM Investors

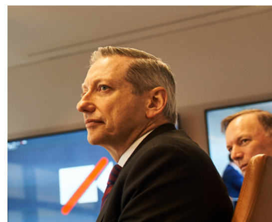
Alex is responsible for the firm's economic, financial market and geo-political risk analysis that is key in IFM's investment process. In this capacity he engages with IFM's domestic and global clients on macro-investment trends and themes.

Amy Xie-Patrick
Head of Income Strategies
Pendal Group

As part of her role, Amy provides investment research, strategy and asset allocation insights that can be leveraged off for a wide range of fixed interest products managed within the team.

Anthony Kirkham
Head of Investment Management
Western Asset Management

A 32-year industry veteran, Anthony has served as head of Australian and New Zealand investment management, head of business operations and portfolio manager at Western Asset Management (Western Asset) since 2007.



Scott Haslem
Chief Investment Officer
LGT Crestone

Scott leads the Chief Investment Office at LGT Crestone, covering strategic and tactical asset allocation, portfolio construction and manager selection across equities, fixed income and alternative assets. He has more than 25 years' experience in global financial markets and investment banking.

Stan Shamu
Senior Portfolio Manager
LGT Crestone

Stan works closely with LGT Crestone's investment advisers to understand individual client goals and to deliver suitable portfolios. With over 15' experience in financial markets and managed investments research across multiple asset classes, Stan has a wealth of experience in constructing portfolios and developing strategies for clients.

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Near-term risks still elevated

Uncertainty over the near-term outlook for the world economy remains elevated. The distance between the two most likely global outlook scenarios—one where growth slows materially over coming quarters but recession is avoided, and the other where recession is not avoided—has narrowed. While inflation pressures have clearly ebbed during the second half of 2022, the persistence of 'actual' inflation far above target has again seen the world's central banks guide future policy tighter than expected. And in the US' case, this has been well ahead of the time when the impact of already sharp interest rate hikes could reasonably be assessed, given the usual policy lags.

Fears of a global recession have mounted, together with renewed tension in the war for Ukraine, rising worries about Europe's energy security as winter approaches, and a flailing China property sector. Volatility has intensified, particularly in currency markets, and bond and equity returns have once again moved sharply weaker during Q3.

At LGT Crestone's most recent investment forum, we asked panellists to discuss their near-term outlook, given these current uncertainties. In particular, we asked how they viewed the most likely central case scenario for the world and Australian growth over the coming year. Panellists were asked to consider whether equity markets had troughed, or if further downside movements were likely, and the extent to which the rising yield environment had rendered fixed income a more competitive asset class to equities.

Overall, our panellists believe that the near-term environment remains one of elevated volatility and heightened risk. A shallow global recession through 2023 was broadly viewed as the more likely scenario, as central banks are likely to need a sustained period of below-trend growth to ensure inflationary pressures dissipate. However, Australia was viewed as somewhat less vulnerable, given its exposure to high commodity earnings and lower inflation risks. For markets, despite near-term risks, participants noted the longer-term potential for supportive valuations in equities to emerge as the corporate earnings outlook corrects more in line with the macro-economic outlook. Moreover, compared with the past decade, non-equity assets are expected to be favoured in portfolios, given a persistent higher yield environment.

Three themes emerged from the forum:

- **The outlook for 2023 remains uncertain, hidden within a range of now only downside scenarios** - Market volatility has risen and the narrative around whether we can expect to see a recession has shifted. Investors appear confronted by a range of only 'downside' scenarios, dominated by 'recession' or 'just avoiding recession'. Our panellists viewed the outlook as very much in the hands of central banks, where the risk of over-tightening and a shallow recession in 2023 has risen, a necessary evil to ease pressure in tight global jobs markets. Our panellists saw US and Australia as regional outperformers, while recession in the UK and Europe was assumed. In contrast, if China's property sector weakens for an extended period, then the future growth rate for China will likely be a lot lower than anyone expects.
- **There were still plenty of factors that could see equity markets move lower near term** - In the short term, panellists agreed that investors are unlikely to be adequately compensated for risk. They see slowing macro data signalling that earnings expectations are too high, as are bellwether semi-conductor company reports. Rising costs are considered a significant threat to future earnings and profit margins. However, once the outlook was stretched beyond the near term, some of our panellists viewed market pricing for some companies and sectors as starting to become "extremely attractive." Panellists saw short-term opportunities in Japan and China, while domestically-focused companies in all regions should be able to avoid globally slowing revenue (and currency) risks.
- **Government bonds and investment grade credit (as well as defensive unlisted assets) are now an increasingly competitive asset class to equities** - With the risk-free rate having been so low over the past decade, investors needed to climb the risk curve and invest in equities and emerging markets to chase a higher yield on their investment. However, now that the risk-free rate has increased, investors should be doing the reverse. Looking ahead, the deflationary factors experienced pre-pandemic are likely to return (though rates were unlikely to fall as low as they have recently). A number of panellists are overweight private assets, including infrastructure (deemed attractive due to inflation-linked cashflows), with a preference for regions with regulatory stability.

Is a recession really on the horizon?

Fears of a sharp slowdown in global growth have continued to intensify over recent months. Inflation has proven to be stickier than most expected, interest rates have risen more rapidly, the war in Ukraine has persisted, and there have been ongoing challenges in the property sector in China. Consequently, market volatility has risen and the narrative around whether we can expect to see a recession has shifted. Our panellists discussed whether we are likely to see a recession, whether inflation is peaking, and if banks can avoid overtightening.

We are in the hands of central banks

Alex Joiner, Chief Economist at IFM Investors, reflected on where we were 12 to18 months ago, noting that investors were able to consider a range of scenarios, which included an "upside" case. Economies were emerging from the pandemic relatively unscathed and there had been the potential for some upside due to monetary and fiscal stimulus measures. Now, investors are faced with a range of "downside" scenarios, which include recession (such as in the UK and Europe) and just avoiding recession (such as in the US).

Anthony Kirkham, Head of Investment Management at Western Asset Management, believes we are now in the hands of central banks. The US Federal Reserve (Fed) is determined to squash inflation. And while he feels this approach makes sense, he acknowledged that "if you're going at speed, you're more likely to crash".

Amy Xie-Patrick, Head of Income Strategies at Pendal Group, agrees that the Fed is determined to prioritise the fight with inflation. She highlighted the economic relationship between high inflation and high volatility in markets, and that market volatility leads to bad economic outcomes. She feels the Fed may think that if it does not control inflation today, it will create a much bigger problem for itself further down the track. She also discussed how fiscal policy in some countries was adding fuel to the fire.

"Perhaps if there was a danger of destabilising the financial system, the Fed might slow the rate of interest rate hikes. But, at the moment, it can't afford to let inflation take equal place to growth."

Scott Haslem, Chief Investment Officer at LGT Crestone, commented on the mixed reaction function of central banks. He explained that on the Fed's part, its commentary has remained consistent in terms of needing to keep tightening monetary policy until inflation is at 2%. However, this is in contrast to 20 years of monetary theory, which cautioned against ignoring the long and variable lags of monetary policy.

Joiner added that the Fed's mindset is that short-term economic pain is better than long-term, persistent inflation. The Reserve Bank of Australia (RBA), however, is taking a more pragmatic approach, assessing the impact of interest rate hikes on Australian households before raising rates too quickly.

Is inflation peaking?

Katie Petering, Head of Product Strategy at BlackRock Australia, explained that inflationary pressures have been driven by production constraints, exacerbated since the pandemic. Blackrock is currently watching the labour force participation rate, and has not yet seen any signs that supply-side issues in the labour market are easing. BlackRock believes central banks are set to overtighten policy in the near term, causing economic damage. It believes that high inflation will be persistent and central banks will be forced to live with inflation as they see the effect of rate hikes on growth and jobs. Although Blackrock feels that inflation will drift lower from here, Petering explained that central banks will need to see a 2% drop in output to get inflation back to target. This equates to roughly 2 million Americans being out of work.

Xie-Patrick explained that the US is currently experiencing a wage price spiral. The labour market is still very tight, and some of President Trump's immigration policies had contributed to this. However, she commented on the recent JOLTS (Job Openings and Labor Turnover Survey) print, which showed a significant fall in vacancies, but noted there is a time lag with this data.

"Those vacancies are probably bloated compared to what the true vacancies are. Companies are already likely taking those job ads down."

Mick Dillon, Portfolio Manager at Brown Advisory, believes that inflation is being driven by supply-side factors, and that the real issue is "unexpected" inflation. While emerging markets have planned for high levels of inflation, developed markets have not.

Dillon explained that a key driver of inflation is the labour market, and that there had already been some tightening in the US labour market before the pandemic, with corporates raising wages to attract staff. He feels the labour market will be the key driver if the UK and Europe fall into recession.

"There just aren't enough people to employ when you're under 6% unemployment in Europe and under 3% in the UK."

According to Joiner, job market participation is a key issue. Although it has been fairly consistent in Australia, in other countries fiscal policymakers could be taking pressure off central banks by encouraging participation. As an example, in the US there is a 0.9% gap between where we are now and where we were in 2019.

With inflation likely to remain above target for an extended period, Joiner believes that it will be key for investors to invest in strategies that can cope with this scenario.

Which economies will fare better?

Haslem explained that most consumers globally have excess cash on their balance sheets. He commented that this economic cycle is unusual as normally, once interest rates reach neutral, consumers are already geared and the impact of rate hikes is reasonably quick. Now, he explained, we have a situation where consumers have excess cash, and there is a great amount of uncertainty around how consumers will behave as interest rates rise.

Kirkham believes the US and Australia are likely to fare better than most other economies, while Petering sees the US at risk of tipping into a recession. However, she sees this as unlikely to happen until next year, and if the US does enter recession, it is unlikely to be a deep recession.

Dillon explained that in the US there are a high number of people on 20 to 30-year fixed-rate mortgages. With few people refinancing at current interest rates, the rise in interest rates do not impact discretionary spending as much as seen in the UK or Australia, where mortgages are typically variable rate.

Xie-Patrick added that in the US, although a strong US dollar is beginning to have an impact on households, it does not appear to have impacted corporates yet.

"Corporates have now finally emerged from repairing their balance sheets following the GFC, and credit growth is expanding at a double-digit rate after a decade of low single digits."

Xie-Patrick feels Europe is the most obvious pain point due to the energy crisis, war in Ukraine, and its fortunes tied to China's economy. Petering agreed that the UK and Europe are at risk of falling into recession this year.

Is Australia a relative outperformer?

Haslem commented on the thesis that Australia could do quite well in this environment as it is a net energy exporter. Rising commodity prices will generally benefit Australia, and in the near term, Australian growth may outperform other regions.

Joiner feels that Australia might do well in a relative sense—largely as a result of good luck rather than good management. However, he acknowledges that the RBA's recent decision to hike interest rates by 25 basis points (bps) rather than 50bps could be the first sign of good management. Joiner believes that Australian consumers are at a crossroads. While they have excess cash on their balance sheets, they are uncertain about what they should do with it.

"Deposit rates are becoming competitive—but as a mortgage holder, the best place to put your money is in a mortgage offset account."

He explained that Australia's terms of trade and population growth should work in its favour. The terms of trade provide the Government with a $50 billion surplus in the budget. While that will likely fall, it is probably some distance away. The Federal Budget has forecast around 1.4% population growth, which is significantly higher than other developed economies.

"It's harder to have a recession in Australia because we have a significant margin to start with. The RBA has forecast 1.7% growth to 2024, implying 0.4% per capita GDP growth. Holistically, real GDP looks like it will be robust because of that reason."

What is the growth outlook for China?

Xie-Patrick explained that, during the pandemic, policymakers in China attempted to stimulate the economy, which subsequently made its way into the property sector. Now, the property sector is experiencing one of its worst downturns in history and the Government appears resolute on "keeping its foot on the brake", even if that leads to corporate defaults. Xie-Patrick explained that, in some cases, large companies have failed—and some of these have had strong ties to the state government.

Xie-Patrick believes that if the property sector weakens for an extended period, then the future growth rate for China will likely be a lot lower than anyone expected—and possibly more similar to that of a developed economy's growth rate.

With growth in China now entering a very mature stage of the development cycle, this may have a negative impact on the Australian economy. And while the National People's Congress may see a gradual relaxation of the zero-COVID policy, this is likely to provide more of a boost to China than Australia. This means that Australia will need to look to other sources of structural growth, relying less on its commodity exports.

What does the stronger US dollar mean for investors?

Petering highlighted that the stronger US dollar has impacted most assets, and explained that BlackRock has moved overweight the US dollar to create a buffer for portfolios. Xie-Patrick added that a stronger US dollar has created headwinds for emerging market economies, who have been forced to start their hiking cycle earlier than desired.

"For a while, emerging economies had a huge real rate advantage. Brazil has had in the region of 13% worth of hikes and is still not in a recession. With the Fed now hiking at a pace not seen in modern history, it's forcing emerging market central banks' hand."

The LGT Crestone view: We continue to believe a broad-based global recession can be avoided—but greater evidence is needed that actual inflation is on a downward path and 'demand destruction' is sufficient to ensure future inflation stays on that path. LGT Crestone is tactically overweight domestic equities.

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Alex Joiner
Chief Economist, IFM Investors

Are equity investors being adequately compensated for risk?

Rising inflation and interest rates have created a headwind for equities, and a plethora of near-term challenges, such as geo-political risks, a downturn in China's property market, and potentially 'unhelpful' fiscal support remind us that we are investing in a period of heightened uncertainty. We asked our panellists whether investors are currently being adequately compensated for risk, and which regions and sectors currently present the best investment opportunities.

How should investors be positioning in equities for the next 12 months?

With Fed Chair Powell commenting that the Fed needs to bring inflation under control, Haslem feels that this means there will need to be a sustained period of below-trend growth. He assumes this means a period of weak corporate earnings.

Petering said that BlackRock feels the S&P 500 index has further to fall and that investors are not being compensated for equity market risk—particularly for developed market equities, an area where they are underweight.

"There is a relationship between ISM Manufacturing PMIs [purchasing manager indices] and S&P 500 earnings revisions. Key new order leading indicators showed the sharpest contraction since the COVID-19 shock. Earnings revisions are turning lower—but BlackRock thinks there is further to go as Q3 earnings season starts next week."

BlackRock is expecting lower earnings and revisions to unfold, and feels that over the next six months investors will be better compensated in areas such as credit. It is underweight equities on a three to six-month view.

Dillon feels semi-conductor companies are a great indicator of the underlying economy. He feels there is a quick readjustment taking place in earnings.

"Companies are seeing pressure in the supply chain and cost of goods sold. There is also pressure in labour markets, and rates are going up. Capex replacement costs are rising exponentially."

He feels there is little opportunity for corporates to offset these costs, unless they have demonstrable pricing power, and admits that forecasting in this environment is difficult.

"Assuming any near-term issues will smooth out over time, the second you stretch duration to 5 years from 12 months from an equities perspective, some companies are trading at a 30% discount. This looks extremely attractive. Having said that there is a risk of being early."

Xie-Patrick believes that while revenue may have fallen, margins have been at all-time highs, so this does provide a bit of a cushion.

However, it is not clear how long it will take for that earnings correction to emerge. She explained that indicators, such as the US ISM Manufacturing New Orders component, point to a 5-6% downgrade in earnings over the next six months, although this has not yet transpired. Since corporates have decent cash buffers and strong balance sheets, she suggested that earnings may prove to be more resilient than usual.

Which regions and sectors present the best opportunities?

Petering believes that Japan is a standout, supported by easy monetary policy, supportive dividend payouts, and cash buffers on balance sheets.

Dillon likes domestic companies globally (i.e. companies with domestic revenues and domestic costs) as this removes global revenue risk. However, as a US dollar investor, currency is the biggest risk. In terms of sectors, he feels that valuations in bond proxies, such as healthcare, are beginning to look interesting.

Xie-Patrick feels China could present a short-term opportunity. Australian investors are currently playing 'tug-o-war' with Chinese investments. On the one hand, China's weighting in global indices is only likely to grow, but on the other hand, there are increasing geo-political risks to consider. However, with valuations at very low levels, and if you believe there is a lot of pent-up demand which could emerge at the end of China's zero-COVID policy, this could be a short-term play. Longer term, however, there are structural challenges to contend with.

The LGT Crestone view: Valuations are less extreme, but the earnings growth outlook has started to lose momentum. Relatively high commodity prices are a relative positive for Australia, supporting the current overweight. We are underweight Europe and neutral in the US, UK and emerging markets.

Do fixed income and alternatives present opportunities?

With yields rising sharply, bonds are beginning to look interesting again. This has led investors to suggest that fixed income will reclaim its status as a worthy diversifier. However, a rising rate environment can present challenges for fixed income investments. We asked our panellists to discuss their outlook for fixed income and asked whether alternatives present an attractive opportunity in this environment.

Which factors should be influencing an investor's exposure to fixed income?

Haslem explained that an investor's view on fixed income will partly be influenced by their view on secular stagnation and similar themes over a three to five-year time frame. Where fixed income fits in a multi asset portfolio strategically and tactically will depend on whether investors believe inflation will be higher than average and interest rates are stickier. He added that consideration also needs to be given to long-held views around technology and demographics, and whether these will return to the fore, ultimately lowering inflation and interest rates.

What is the interest rate outlook for the next three to five years?

Kirkham stated that a typical core bond fund investing primarily in government, investment grade, high quality issuers had a yield of around 1.1% in August 2021, but this is now close to 5%.

"If you can get that level of yield without taking much risk and you can still get a positive return, even if it goes a whole percent higher, why wouldn't you take out that sort of insurance?"

Xie-Patrick explained that with the risk-free rate having been so low over the past decade, investors were forced to climb the risk curve and invest in equities and emerging markets because there was no yield. Now that the risk-free rate has increased, she feels investors should be doing the reverse. She prefers investment grade credit over other credit categories as it provides a liquidity premium on par with near-crisis or recession-type levels.

"High yield credit isn't there yet. It's implying default rates that you see in recessions and times of crisis. You're simply not getting the liquidity premium in high yield—and similarly in emerging markets, they're yet to find a bottom."

With regards to credit beta, Xie-Patrick prefers shorter-dated exposures and less rate-sensitive sectors. However, she acknowledges that for investors who have already gone up the capital structure, they are less likely to be impacted by volatility and will be able to enjoy a more assured income stream.

What is the outlook for long-term rates?

Kirkham feels that the deflationary factors experienced pre-pandemic are likely to return. Government debt generally increased through the pandemic, and as we have borrowed from future growth to some extent, this will need to be paid back at some point. He also feels that demographics and technology factors will likely drag on growth.

Joiner added that Australia was one of the stronger economies to emerge from the pandemic. He expects the risk-free rate in Australia to settle around a much lower average than it has historically, and commented that central banks may be inclined to keep rates around 2% rather if we were to tip into a recession.

What value do alternative investments present?

Petering said that BlackRock currently has a relative overweight to private assets. Infrastructure is particularly attractive due to its inflation linked cashflows and opportunities in the transition to net zero, while BlackRock is cautious on real estate. She stressed, however, that investors need to remain cautious and selective about where they invest.

Joiner explained that IFM Investors prefers long-dated, monopolistic infrastructure assets, as these have been great inflation hedges. Its core portfolios have an inflation beta greater than 1. He explained that because these assets are so long-dated, factors such as geo-political risk are considered closely, which can make some emerging market exposures challenging. IFM Investors prefers to invest in jurisdictions with regulatory stability, such as Europe and the US, and sees renewables as remaining in demand. He noted that industry funds currently have around 25-30% exposure to private markets, and sees this trend growing among global investors.

The LGT Crestone view: We are underweight short maturity and high yield credit, neutral investment grade credit, and overweight government bonds, as they have largely incorprated an aggressive rate hiking cycle. Within alternatives, we favour core real assets and private debt, and highlight the ongoing importance of manager selection.

Where would you allocate your incremental dollar?

Mick Dillon
Portfolio Manager
Brown Advisory

"Equities are still a great investment if you take a long-term view."

Katie Petering
Head of Product Strategy
BlackRock Australia

"I would invest in investment grade credit, inflation-linked bonds, and global macro hedge funds."

Alex Joiner
Chief Economist
IFM Investors

"In this environment, I would allocate to infrastructure and bonds."

Amy Xie-Patrick
Head of Income Strategies
Pendal Group

"I have a preference for investment grade credit, inflation-linked bonds or inflation swaps."

Anthony Kirkham
Head of Investment Management
Western Asset Management

"I would be allocating to bonds."

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