Expert round table

When markets and economies collide

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MACQUARIE

When Markets and Economies Collide

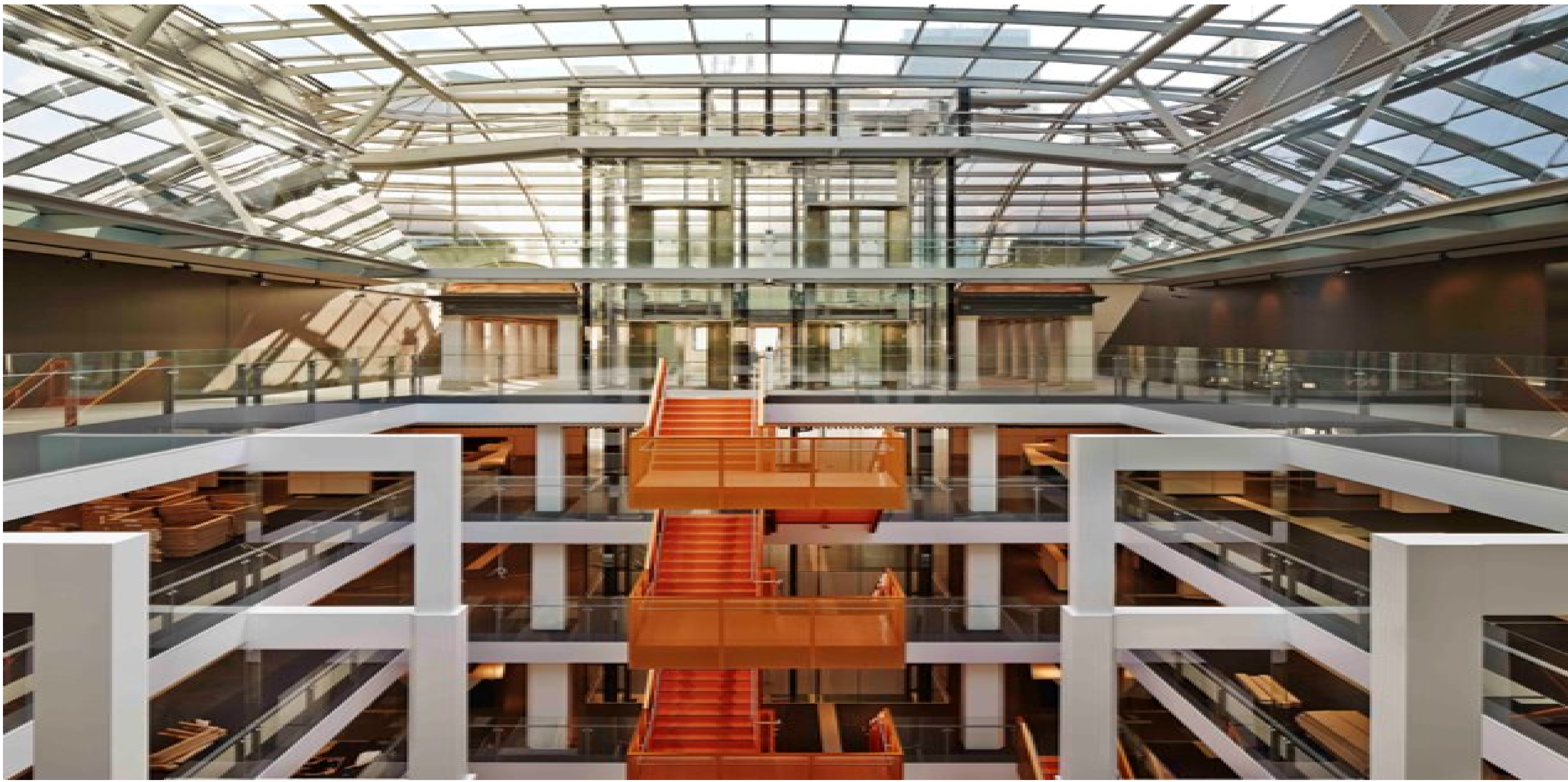
1H20 has been a testing time for investors. COVID-19 has been an unfamiliar and underestimated shock to the global system with social containment measures driving the deepest global economic downturn in decades.

Equities suffered their fastest bear market correction since the 87' crash with bond yields falling to new record lows. However, the financial market panic proved fleeting. 30 days after the equity market sell-off began, they bottomed and began a rapid accent. Now 3 months, several key global equity market indices are either at all time new highs or close to it. This is despite the ongoing global health crisis, bond yields barely budging from record lows and most economies still on large doses of life support.

Faced with this backdrop and the challenges ahead, we invited a group of market experts to provide their views on how to navigate the outlook. In line with the world we live in, this roundtable has been conducted in the relative safety of cyberspace via a Q&A session. We provide a summary of the key takeaways from our experts and then the full transcript of our Q&A session.

Our round table panelists include:

- **Johan Carlberg,** Principal and lead portfolio manager, Alphinity
- **Brett Lewthwaite,** CIO and Global Head of Fixed Income, Macquarie Investment Management
- **Frances Lim,** Managing Director, Global Macro and Asset Allocation, Kohlberg Kravis Roberts (New York)
- **Jun Bei Liu,** Portfolio Manager, Tribeca Investment Management (Sydney)
- **Gerard Minack,** Founder Minack Advisors
- **Jason Todd,** Head of Investment Strategy, Macquarie Wealth Management



Disruption creates opportunity

The panel were generally optimistic that the global economy would bounce back although most agreed that it would take some time before growth would normalize and begin rising at a sustainable pace.

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The nature of the virus and the inconsistent response to it from different countries, states and even cities suggested to Brett that the recovery would be inconsistent and potentially drawn out. Johan pointed out that while markets have reacted optimistically to a resumption of activity, even without further outbreaks, a lot of damage had been done to the global economy and history suggests that economic recoveries play out over years, not months.

Frances discussed the longer-term implications for growth from the substantial amounts of fiscal and monetary stimulus injected to support the global economy and reminded us that deleveraging from large debt loads is a painful process as governments are forced to add salt to injury by raising taxes to cover the fiscal gap. On top of this, at some point, central banks will also have to unwind quantitative easing and lift interest rates.

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Gerard provided an interesting angle and argued that even before COVID-19 policy makers had recognised that fiscal policy would need to take over from monetary policy as the principal tool of cycle management. By synchronising fiscal expansion with central bank Quantitative Easing (QE) programs, the western world has effectively shifted to helicopter money – which if continued - will bring the curtain down on the secular stagnation era with significant implications for the investment trends we have become use to.

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On the scale of policy support, Brett argued that while central banks can keep "doing more," they actually cannot really address the virus itself, nor can they influence the period of time we will be required to socially distance. But policy support would help prevent cash flow impaired or deficient companies from becoming insolvent as well as helping to maintain elevated valuations. However, unless there is a vaccine, or a swift return to normal, it would be wise to maintain your distance from many companies, particularly those in the services sector who would remain vulnerable to weak cashflows and growing debt burdens.

Gerard was not particularly worried about the disconnect between the real economy and the equity market. Typically, US equities rally off recession lows 4-6 months before the recession ends. That is what has happened this time.

Similarly, Johan argued that the equity market is always forward looking so it is not unusual for it to start recovering well before the economy. In fact, the equity market is one of the best leading indication about the likely direction of the economy.

The equity market is one of the best leading indicators for the general economy ”

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While markets have run hard, leaving them vulnerable to disappointment, Jason thinks the commitment of central banks to ensure that economic consequences are minimized is very strong. Similarly, we have already seen that the tolerance level for financial market volatility and/or weakness is very low on the basis that policy makers do not want a negative feedback loop to develop.

Johan expresses a similar view and while he thinks it's unlikely that we will go back to the March lows, he remains concerned about the speed and extent of the market rebound which has confounded many investors including himself. That said, equities as an investment always need to be compared to other asset classes such as bonds, cash and property. In that comparison, equities still look pretty good.

Frances points out that one of the key trends to emerge from COVID-19 was the importance of environmental, safety and governance, or ESG issues. ESG isn't just nice to have, it's good business that yields good results and likely leads to more profitable businesses. Over the past few years, we have seen an escalation of global issues that created an intersection of Global Trade, Rule of Law, and National Security. Today, national security isn't just defense-related, but now encompasses tech security, healthcare security, water security, food security and energy security. Thus, we believe ESG will play a huge role in future investing decisions in all these sectors.

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An emerging point of discussion has been whether the extraordinary levels of policy support will lead to an outbreak of inflation. Brett argued that consensus is always eager to focus on potential inflationary pressures and is again doing so. Prior to the pandemic the global economy with structural disinflationary pressures despite numerous rounds of once unthinkable amounts of QE. While we acknowledge inflation could emerge in pockets and differing countries, we do not believe investors should be worried about it at this time.

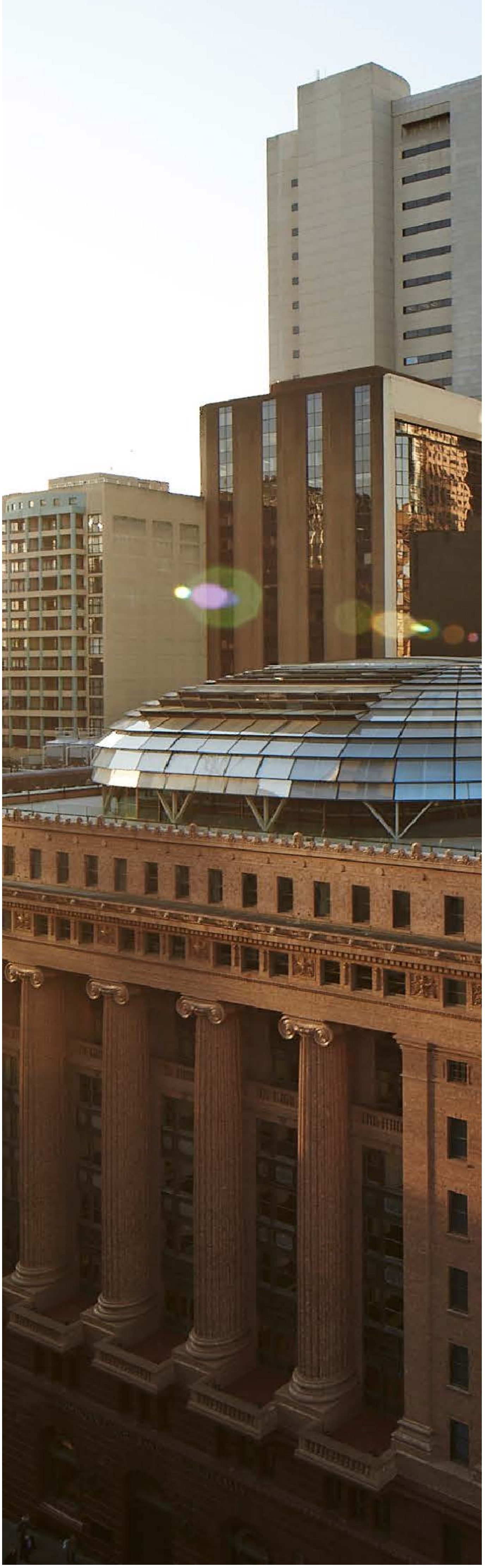
Shifting toward what the implications are for financial assets, Johan thinks that the usual drivers like economic growth and company innovation are intact for the equity market. Having said that, the Australian equity market is currently pricing in a very sharp rebound in company earnings and even as far out as F22 the market is trading on an earnings-multiple (17.5x) well ahead of historical levels.

Gerard stated that the difficulty in setting an investment strategy now is that there may be a major inflection point in the next 12-18 months. The risk-reward trade-off on many risk assets now looks unattractive on a 12-18-month view. Moreover, the likely winners in that time frame will reflect what is likely to remain a disinflationary environment. Tactically – 2-3 months – he can see markets continuing to rise. But thereafter, looking into 2021 returns will be poor.

I can see markets continuing to rise on a 2-3 month basis, but the risk-reward trade-off on many risk assets now looks unattractive on a 12-18-month view ”

Johan breaks the Australian market outlook down to a more micro level and thinks of the COVID-19 impact on stocks and sectors as breaking into two categories. In the first, are the stocks that have been either positively or negatively impacted by the pandemic in the short to medium term and in the second are stocks that are likely to have seen a more enduring change to their market opportunity.

On the substantial rotation towards so-called “value” stocks, Jun Bei says this is not a growth to value rotation but rather a demonstration of how the market can ignore sectors and the changing dynamics – and then performance catches up all in one go.



Jun Bei says the biggest risk that she sees to the Australian equity market is the steep escalation in political tensions with China – which offers both enormous opportunity for growth across many sectors – however, this also represents the biggest risk. Any disruption to the trade relationship will be devastating for our economy and prospects.

China is our largest trading partner…any disruption to the trade relationship will be devastating ”

She recommends investors have a balanced exposure within Australian equity portfolios, including to growth stocks, highlighting that in a low interest rate environment, growth assets will continue to gain traction as investors globally struggle to find growth.

Within fixed income, Brett recommends being selective and remaining patient. Maintain your distance, particularly where rewards do not reflect the risks. Bond yields are unlikely to shift higher – as such maintain duration levels in portfolios. Accumulate Investment grade credit, especially on weakness - Avoid industries that require a return to ‘normal’ to survive. Select large industry champions and avoid peripheral companies in impacted services sectors. Seek weak entry points to add High Yield – valuations and security selection will be very important. Add selectively to Emerging Markets – maintain a quality bias, not all countries (especially EM) have been impacted the same, as such opportunities exist.

Maintain your distance, particularly where rewards do not reflect the risks. Bond yields are unlikely to shift higher – as such maintain duration levels in portfolios ”

The risks within private equity are multifaceted highlights Frances. There is the macro environment - if it’s not the coronavirus, there are the upcoming US elections, escalating US-China tensions, India-China border skirmishes, North Korea and South Korea standoffs or China’s National Security Law on Hong Kong. While not a base case, there always the funding risks if markets seize up and lastly, there is the potential for policy risk. However, these challenges also present opportunities for Private Equity. Not all firms can navigate these disruptions, and many will turn towards a trusted partner to help them problem solve in what could be quite stressful conditions. Year-to-date, there have been a number of such opportunities for Private Equity firms.

Biographies

Johan Carlberg founded Alphinity Investment Management in 2010. He is a portfolio manager as well as having responsibility for Chemicals, Paper & Packaging, Building Materials and small industrial sectors. Johan was previously a Senior Vice President and Director, Australian Equities for Alliance Bernstein's Australian Equities fund, responsible for managing Alliance's Australian equities portfolios, from 2003-2010.

Prior to joining Alliance, Johan worked with Robur Asset Management in Sweden as Equities portfolio manager, managing domestic as well as international equity portfolios. Before Johan worked with BZW Australia as an equities research analyst responsible for the Paper/Packaging, Food/Household and Alcohol/Tobacco sectors, leaving the firm as Associate Director. He started his career with Ohman Fondkommission in Sweden as an equities research analyst covering the Pulp & Paper sector.

Brett Lewthwaite is the chief investment officer (CIO) and global head of fixed income for Macquarie Investment Management (MIM), responsible for MIM Fixed Income's (MFI) cash, credit, fixed interest, and currency portfolios which amount to approximately $A180 billion ($US130 billion) of assets under management.

Brett's primary investment and portfolio management focus is on global and multi-sector fixed income portfolios. He has been the lead portfolio manager of the highly regarded Macquarie Income Opportunities Strategy since its inception in 2004. Prior to his role as global CIO and head of Fixed Income, he led the Fixed Income teams in Sydney and London since 2010. Brett has more than 20 years of experience in financial services, and became a senior credit portfolio manager in 2004.

Frances Lim joined KKR in 2011 is a managing director and is a member of the Global Macro, Balance Sheet and Risk team She leads portfolio management and asset allocation for KKR's Strategic Partnership effort (KSPI).

Prior to returning to New York, her role with KSPI, Ms. Lim was based in Sydney, working alongside investment teams in Asia as the Head of Asia Pacific Macro and Asset Allocation. She continues to retain responsibility for the Asia franchise. Prior to joining KKR, she was a vice president at Morgan Stanley Investment Management (MSIM) and a member of the Global Macro and Asset Allocation team. Ms. Lim focused on macro trends and top-down global analysis and was a co-portfolio manager of the MSIF Absolute Return Currency Fund. She also worked as an equity strategist at Fortress Investment Group and Morgan Stanley Equity Research.

Jun Bei Liu is the Portfolio Manager of the Tribeca Alpha Plus Fund, one of Australia's longest running equity long short funds. Jun Bei Liu is a passionate investor with over 18 years of Investment experience covering a large range of sectors, an effective public speaker about her investment views and a regular participant in prestigious conferences such as Sohn.

The last 14 years of Jun Bei's career has been with Tribeca and prior to Tribeca, Jun Bei spent four years as an investment analyst covering the Australian consumer sectors at Morningstar and Foster Stockbroking.

Gerard Minack has been analysing, forecasting and advising on financial markets since 1987. His focus is the fundamental factors that usually drive investment performance: valuation, currency, monetary policy and the economic cycle.

Gerard retired from Morgan Stanley in May 2013. He had been the global cross-asset strategist, and before that Morgan Stanley's global developed market equity strategist. Earlier in his career Gerard worked at ABN AMRO and BZW (both investment banks); Syntec Economic Services, an independent research provider; and in government.

Gerard started Minack Advisors in 2013. It provides fundamentally-based research on financial markets for institutional investors, hedge funds, family offices and sovereign wealth funds around the world.

Jason Todd is the Head of Investment Strategy for Macquarie Wealth Management. Jason began his career with JPMorgan New Zealand as their Equity strategist in 1996. He remained with JPMorgan until 2007 spending time in Sydney as the Australian Strategist, London and then New York as US/Global Strategist. In 2007 he joined Morgan Stanley New York as US/Global Strategist where he remained until 2010 before moving to Asia. Jason most recently was Regional Asian Strategist and Head of Hong Kong / China Equities with CIMB and Head of Australian Macroeconomic Research for Macquarie Bank in Sydney. Jason took up the role of Head of Investment Strategy Wealth Management in 2018. Jason is a CFA.

This report was finalised on 13 July 2020.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return