Episode 15: Geopolitics and the Outlook for Markets

Andrew Garrett, CFA of Perpetual Private and **David McDonald, CFA of IMAP discuss**;

- Perpetual's views on current macro-economic and market issues
- Inflation, interest rates and geopolitics
- Views on key asset classes. Equities v Bonds, alternatives. Offshore v domestic assets.
- Volatility - is it expected to continue?
- Client communication with an emphasis on coping with volatility

IMAP

This podcast series is not meant for retail investors, but instead is meant for financial advice and investment professionals. Please refer to IMAP's website **https://imap.asn.au** for more details.

David McDonald - IMAP (00:13):

Thanks for joining us today on another podcast in the IMAP independent thought series. Today I'm joined by Andrew Garrett, who is an investment director with Perpetual Private, and Andrew and I are going to talk about what's been happening globally and locally in economies and markets in the last little while, and where Andrew sees things heading in the months and year ahead. Welcome, Andrew.

Andrew Garrett - Perpetual Private (00:39):

Thank you, David. Nice to be here.

David McDonald - IMAP (00:42):

So perhaps if we can start, Andrew, maybe with a bit of the geopolitics. I mean, Ukraine particularly, is obviously getting a lot of headlines, but we also keep reading stories about China, Taiwan, US elections are coming up, all sorts of things.

To what extent do you see these different factors, political factors, if you like, impacting markets? And to all extent, do you take them into account in your asset allocations?

Andrew Garrett - Perpetual Private (01:08):

Yeah, it's such a fascinating question, David, and you know, when we think about geopolitics, I mean the whole effect of conflict, particularly when it's conflict, it's quite visceral. You know, there's a reason why it makes front page news because it taps into those very normal human instincts of ours to worry about surviving, right?

And so there is a sense of urgency and importance with any time you get a bit of geopolitical conflict and particularly the case in Ukraine where there's a hot conflict and there's a chance that it might spill over. Not only is it sort of saddening from a humanitarian point of view, but you worry about what that might do to markets from the long view.

Andrew Garrett - Perpetual Private (02:05):

And when we consider how generally complex impact markets there, there is a bit of a contrast in the sense of, on the one hand, we feel that these developments are very important as humans. However, in most cases geopolitical pension war, et cetera there was very little to impact markets. It can feed into a little bit of risk aversion.

It can feed into a little bit of negative sentiment. But, unless you're seeing bombs landing on assets with within your investment framework, it doesn't really do much other than increased volatility.

Over the long term, it does little to harm return profiles. Now, I don't want to be dismissive you know, , there's never a sort of one rule that fits everything.

And you know, when we consider that since the second World war, we went through a very long stable period, which I think many of us took the granted. You know, I certainly grew up in that period and I never thought that would change.

David McDonald - IMAP (03:24):

Andrew, it's interesting what you're saying that lot of these sort of political even hot wars, I think we are calling them, don't necessarily have a big impact on, on markets and, and investment assets.
But I suppose the one everyone's talked about obviously is Ukraine with the inflation impact.

We were told earlier in the year, the energy prices have gone up and some food prices and the like, and that's all because of what's happening there. But do you see that those factors are going to go away? Are you looking at a fall in inflation in the short term, or do you see us stuck with much higher inflation for quite a while?

Andrew Garrett - Perpetual Private (04:08):

Yeah, sure. I think it's worth pointing out the nuance between what I was saying around how these events impact markets in that they don't impact markets directly. They usually they do tend to impact markets a little bit in the ways that you've discussed by influencing other things uses of goods, etcetera.

So you're exactly right. You know, Russia and Ukraine are huge commodity producers you know, there's a reason why the Ukrainian flag is yellow and blue. In fact, there's a reason why the blue is on top because the blue is the sky and the yellow is for sunflowers. And so, that's an acknowledgement of how important sunflower crops are to Ukraine as a nation.

David McDonald - IMAP (05:00):

Yes Ok.

Andrew Garrett - Perpetual Private (05:01):

Yes it's an interesting fact. So you always know if the Ukrainian flag is being hung upside down because the sunflowers are at the top, and sunflowers don't grow from the sky despite their name

Andrew Garrett - Perpetual Private (05:14):

Yes the commodity constraint issue is problematic.

When we think about when inflation first started to emerge in recent years, the expectation from central bankers was that it was transitory. We'll all remember that that was the *"nom de guerre"* of what was going on, that there was inflation, but we're looking through it because we expect it to recede as the global trade environment normalises as supply chains reintegrate and I think there a lot of people have been pretty critical of central banks for getting that wrong.

I also think that's potentially a case of hindsight being 20/20. I think that at the time it made a lot of sense.

Andrew Garrett - Perpetual Private (06:15):

I still think if we didn't know what we already know, that it would make sense for global supply chains getting back to the steady tempo that they had previously. This would've alleviated a lot of that inflationary supply side pressure.

But I guess there are a couple of things, that there was the emergence of the Ukraine Russia conflict, which of course crimped supplies of key commodities, key agricultural and, and industrial commodities. But add to that, the fact that China is steadfastly sticking to the COVID zero or zero covid policy that that hasn't played out. We still have constrained supply chains, and that is holding inflation higher.

Of course inflation involves the interaction of both demand and supply factors. And, when you think about the actions that governments, and monetary authorities rightly took during the emergence of the pandemic in 2020, the demand side has been strongly stoked.

And so that's now coming up against this tight and supply environment. And as we all know from macroeconomics 101, if you reduce supply and you hold demand the same, you're going to end up with increasing prices. And that's exactly what we're seeing.

David McDonald - IMAP (07:51):

I just want to jump in and say though then, Andrew is that the risk that we are talking about now, isn't it?

That if the supply side's not being easily fixed, then the option is for the central banks to hammer the demand side? And that's where we are starting to get talk of recession, isn't it? That, you know, maybe they go too far or that's all they can do with slow economies down?

Andrew Garrett - Perpetual Private (08:15):

Yeah, look I think they need to go far enough. It is a troubling issue. You know the supply constraints won't likely resolve themselves in the short term. And so, in a traditional sort of economic term, demand destruction is ultimately the key in the short term.

And that that does mean likely some degree of pain. I think what I wrote in the quarterly update recently, and what has actually just been echoed by the Federal Reserve in the last day or so, is that ultimately un-employment is going to have to increase to solve this problem. It's hard to see the inflation issue being resolved if it's not for some degree of economic hardship at the margins.

Andrew Garrett - Perpetual Private (09:16):

And that's not pleasant. Nobody welcomes that.

But when you consider that in most developed regions, un-employment is at or near all-time lows, you can probably suggest that there is some scope for that in the system.

But, you know the threat of recession is there we like to think, or we like to remind ourselves that the R word isn't the D word. And by that I mean, recession isn't depression. And the reason why I'm separating those is because a recession in a technical sense is two quarters of negative growth.

So you might have marginally negative growth for two quarters, you're in a recession. However, a depression is, is more pronounced and is really just more of those recessionary factors that form themselves into a, a, a feedback loop so that the, the recessionary factors create more recessionary factors.

Andrew Garrett - Perpetual Private (10:25):

And at the moment it doesn't look like those feedback loops are coming into play. So you know that there's a huge debate over soft landing versus hard landing.

I'm not intending to split hairs when I say I think it's likely to be somewhere in the middle. It's historically very, very difficult to engineer a soft landing. However, the economic impulses, the sort of animal spirits of consumers have behaved relatively well.

You know when you think about the enormous economic shock that the pandemic brought around by what the IMF refers to as “the great lockdown”. The fact that we rebounded from that so well, the fact that economic activity a first, we can't find any examples of economies being shut down by choice in modern history.

Andrew Garrett - Perpetual Private (11:33):

So this is the first time we've ever experienced this, and arguably we got through it just fine.

You know, there was a lot of stress in the meanwhile, and I can tell you, I definitely did not enjoy living under lockdown, but from an economic point of view, it was a flash in the pan. It

was sort of over before, it was over shortly after it started. And you know, it hasn't left that much in terms of scar tissue.

I think that the fact that we're dealing with inflation as a result of too much demand at the moment, or too little supply, you know it just really plays into the robustness that we currently have.
And some of that robustness does need to be shaken. Because once we are talking about feedback loops, a damaging feedback loop is the one of expected inflation. And what really drove central banks to act wasn't inflation itself. It was the “tick up” in expected inflation, which itself becomes a self feeding environment. You know, higher inflation expectations drive higher wage demands, which drive higher prices, which drive higher wage demands. And on you go,

David McDonald - IMAP (12:45):

Yeah, I guess that's what we were seeing here locally before the election particularly wasn't a lot of talk about “real wages have been falling, so we've got to do something about it”.

And people claiming, you know, 5 or 6% wage hikes when inflation hadn't even quite got to that level at that stage.

Yes I suppose if we can just talk a little bit about the interest rate outlook. I mean, we've talked about how central banks are already doing something to try and slow things down and conquer inflation. The markets here and overseas seem to be expecting quite a lot more than what many economists, for instance, and certainly the Reserve Bank here even seems to be suggesting.

So, where does Perpetual sit in that? How far do you think the RBA here, for instance, has to go? Do you see many more hikes or the fact they've already gone down to 25 basis points last time, does that mean they're starting to ease off the brake pedal a little bit?

Andrew Garrett - Perpetual Private (13:45):

You know, I think the Governor of the Reserve Bank - Phillip Low has always been very data driven. And, and I think that's, that's what we saw reflected in the 25 basis point increase as opposed to the expected 50 basis point increase.

We all know that monetary policy is a blunt tool. It works relatively well, but it works in a very imprecise way, and it also works with the lag. And so the fact that we've gone from 10 basis points in March to 2.6% as a cash rate in by the end of September, you know that's a meaningful increase.

And there probably hasn't been enough time for the economy to respond. And this is a bit of a wait and see …..certainly the inflationary pressures in Australia are a little bit protected against some of the more global factors in that the constraint supply environment, which has impacted commodities, has benefited Australia because we are a commodity supporter.

David McDonald - IMAP (15:04):

Sure.

Andrew Garrett - Perpetual Private (15:05):

And then add to that the fact that that those commodities are priced in US dollars and of course being a time of broader uncertainty, the US dollar has strengthened as a result of it being a safe haven currency is people tacking back towards safety.

David McDonald - IMAP (15:26):

Yes.

Andrew Garrett - Perpetual Private (15:27):

So to answer your question which is more about where interest rates are likely to go, I think we would say that they're probably likely to continue upwards. But the issue from the central bank's point of view, (and this isn't just in Australia, this is almost globally), and it loops back to my comments around expected inflation, is central banks need to leave people in no uncertain terms, understanding that inflation will be dealt with because that behavioral impact of that assertion will help minimise any of those feedback loops we're talking about when it comes to expected inflation.

So a little bit like they did in the pandemic is the inverse of what they did then, but in the sense of going, going hard and going early, the same approach is now being taken with interest rates.

When we look at longer term studies - the times when central banks got a lot of the big interest rate increases out of the way early were the times when you more often than not, had a softer landing.

So getting it out early, nipping the problem in the bud increases your chances of a better outcome. And I think that that talks to the feedback loops issue, et cetera.

David McDonald - IMAP (16:59):

Yes. Okay. I mean, obviously one consequence from all of this we've talked about from wars to rate hikes and inflation and so on has been a lot of volatility in bonds, not just equities, which is perhaps a unusual, and I mean, even last night, I think Wall Street went through several percents from a big fall to ending up with a big rise. So what are you talking to clients about there? I mean, to see this volatility continuing for a while and what sort of advice do you give on the back of that?

Andrew Garrett - Perpetual Private (17:36):

Yeah the topic of the day is dealing through volatility and, you know there's sort of some interesting framing devices you can use when you're thinking about it. But the, the main thing with volatility is that volatility is risk in an investment sense and what is risk is uncertainty. And so when we went through that long period post the global financial crisis till effectively the start of 2022 over time you had a growing consensus, which was there's very low inflation and central banks are dovish. They're leaning into easy monetary policy. And so that as an impact meant that everyone was sort of singing from the same hymn sheet or at least had very similar beliefs about the future direction for markets.

Andrew Garrett - Perpetual Private (18:48):

Now in this point - basically from the start of the calendar year, but particularly now in the new financial year, there is a recognition that people are less certain about what the direction of travel is.

And this volatility that we're experiencing is not just a perfect reflection of that, but it's also a representation in the sense that as people adjust their expectations, as people work through the implications of the new environment, they are having to adjust, and it's not just an adjustment around, what do you expect from your equities or what do you expect from your bonds?

It's the expectations across the whole portfolio. So there are for instance, portfolio effects where people start looking and saying, Well, we haven't been able to get anything out of government bonds for five or more years at least, now they're demonstrating a bit of, bit of a return profile.

Andrew Garrett - Perpetual Private (20:00):

They are thinking maybe we should be drawing a little bit away from other asset classes and putting it back into those traditionally more defensive asset classes. And those are the sort of things that happen.

You'll get sort of different phases of people adjusting and then rechecking where they're at and then readjusting. And what that's going to do is continue to feed volatility.

And so when you ask how are we're communicating with our clients? the thing we're just pointing out to them is there's going to be more of this. Forewarned is forearmed and that we expect more of these bumps along the way. We don't expect any of them to be at this point in time to be system breaking(given the information that's available).

Like what we had in the GFC itself was more of a problem of banks losing confidence in each other and, and that the whole system froze up as a result, we're not seeing any of those systemic problems. Now, this appears to be, at this point in time, more of a standard adjustment to a new tone in the investment landscape.

David McDonald - IMAP (21:14):

So do you, given the uncertainty and, you know, continued volatility and so on, you're mentioning Andrew, do you therefore not take strong views at the moment or, you know, are there particular asset classes you still have a bit of a favorable view of?

Andrew Garrett - Perpetual Private (21:32):

Yeah, so I think it's worth pointing out at this point is we don't tend to take tactical or dynamic asset allocation views. We do recheck out capital market assumptions and therefore our strategic asset allocation views on an annual basis. But the intention isn't to make huge changes at an asset class level. What we tend to lean into is the fact that we engage, and empower the managers that we use within asset classes to make those dynamic changes. And you know in other forums I've spoken before about how when you've got managers (particularly using equity managers an example) who are very much at the coal face speaking to company

management all the time, and they tend to pick up tremors in the economy very, very early from those conversations, you know, changes in ordering behavior, et cetera.

Andrew Garrett - Perpetual Private (22:29):

And so what, what you can do if you're not careful is, let's say you were to contemplate going underweight equities, your equity fund managers might also be going defensive at the same time. And so you may be ending up sort of doubling up that risk reduction. And so look, that's not to say we don't have asset class views. We certainly express those within asset classes and when we reweight managers. And as I said we do update our capital market assumptions. So something we've been a strong believer in for some time alternatives as an asset class. I mean, I do feel a bit awkward calling them an asset class because it's almost another world unto itself. You know, that there are many asset classes within alternatives.

David McDonald - IMAP (23:21):

Yes, that's true

Andrew Garrett - Perpetual Private (23:21):

Alternatives as a homogenous group doesn't really exist. But we actually created our own alternatives program here. We scoured the market for something to enhance portfolio experience for our clients and couldn't find something that quite fit what we were trying to achieve. So we ended up building our own and that that's really paid off for us.

We believe that intellectually, and sort of academically, it's a period like this where pretty much every asset class is showing negative returns and at least our growth alternatives are still showing positive nominal returns, not just relative, but nominal. So, you know, alternatives are something that in the sort of ebb and flow of global capital markets do tend to be a little bit of a safe harbor.

Andrew Garrett - Perpetual Private (24:17):

They do tend to be a little bit sheltered from the worst winds of the storm. That doesn't make them immune. And we're certainly very cautious around the way we approach that. But, you know, alternatives do still show more value. And when you think about the valuation methodology used for, for alternatives, it's far less of a momentum based market. And so you do get that somewhat protected. Like I said you tend to get whipped around less by broader market volatility.

David McDonald - IMAP (24:57):

Yeah, I guess the, the question there may be a lot of people have been talking about alternatives, and it certainly become a, a popular thing in the last few years was to, you know, whether it was the benefits more from the, the low interest rate environment and whether higher real yields even potentially at the moment, particularly higher bond yields might make some of those alternatives less attractive. But it sounds like you, you're still quite keen on, on that.

Andrew Garrett - Perpetual Private (25:26):

Look, as I was alluding to in my comments around the asset class as a whole, there will be areas that do get impacted. You know we by our nature tend to be a bit conservative in our investment views. And, and by conservative I more mean we try to reduce return expectations as much as possible. And we tend to focus quite closely on the risk management side of things. So when I was talking about the fact that we have our own alternatives program, which we created for purpose, a key reason we did that was we felt that alternatives should provide an alternative source of beta, You know they shouldn't necessarily correlate negatively correlated to broader markets, but they should be lowly correlated.

Andrew Garrett - Perpetual Private (26:21):

To take a one more extreme example, things like listed infrastructure, we wouldn't necessarily a) call them an alternative, and b) they're certainly not going to give you a low level of correlation because just by being listed puts them more at the whims of markets.

So for us yes, we are believers in alternatives, but we do feel that the devil is in the detail. It's not just one broad brushstroke. And the thing with alternatives is because they are less liquid, you need to be doubly sure when, when you go into them because quite often if they aren't performing well there's, there's not an accent. And so, you know, they are conceptually " buy and hold strategies" because the last thing you want to be doing is trying to find someone take it off your hands in the secondary market when it's performing badly.

David McDonald - IMAP (27:19):

Thanks look we've had a great conversation and we've discussed everything from war in Europe to the outlook for inflation and interest rates and the benefits of alternatives. So really thank you for taking the time to talk to us there today.

So it does just remain for me to say thank you to **Andrew Garrett, Investment Director from Perpetual Private** for joining us today, and let you know that there are more upcoming podcasts and webinars from IMAP, and you can see more detail of those on our website **https://imap.asn.au**.