Silver Linings – 2022 and 2023

Hello, and welcome to the first in our new series of Conversations, a monthly podcast from GSFM. We aim to bring you a lively discussion with a range of investment experts, focused on concepts and outcomes of interest to you and your clients.

Our first series focused on income. This second series will focus on the silver linings, that advantage that comes from a challenging situation, and we know that 2022 has been full of those.

To get the ball rolling, GSFM CEO, Damien McIntyre, and economic expert and self-confessed bond tragic Stephen Miller, will look back over 2022. Together, they'll look back at a year characterised by inflation, monthly interest rate increases, and volatility across all financial markets. Where were the silver linings and, more importantly, what can we expect in 2023?

Before I hand over, I need to read this important notice.

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This podcast was recorded on Thursday, the 1st of December 2022. Damo and Steve, take it away.

Damien McIntyre

Thank you very much, Tracey, and welcome everyone to the new series of our podcast series, and welcome to you also, Stephen.

Stephen Miller

Thanks Damo.

Damien McIntyre

Now 2022 ... I can recall January of this year, equity markets started to tumble on the back of rising inflation. The analogy I'll use is like being a kid in the front row of the Big Dipper at the top of the hill, just as you tip over to gain speed as you run down that first hill, and I thought to myself, "If inflation continues to build this momentum, it's going to be a big year," and by golly, by crikey, it was a big year for inflation, Steve.

Stephen Miller

It certainly was, Damo. I think there's a couple of things in that, and I think the seeds of this year's inflation and what we saw subsequent to that in financial markets, was set in 2021, where central banks universally were slow in recognising that the magnitude and the persistence indeed in inflation, and the rhetoric was all ... you recall, 2021 was full of rhetoric about transitory, inflation's transitory, and it took a long time for central banks to jump off that.

Now the Fed did that toward the end of 2021, and I actually think the Fed's been quite successful in its attack on inflation, and it may have set us up at the end of 2022 for a better period, but certainly inflation surprised, and I think

the problems were magnified by the fact that through 2021, central banks were slow to recognise that this was serious.

It was more than transitory, and therefore they were slow to move to adjust settings to the new reality, particularly, I think, when you recall, we were all a little bit focused on the pandemic still at the start of 2022, and by that stage it had emerged that the dislocation that was coming from the pandemic was nowhere near as bad as everyone thought, yet central banks were slow to adjust those emergency settings which allowed inflation to develop that momentum. As I said in my introductory remarks, what we saw in financial markets subsequent to that, was something we hadn't seen for quite some time, probably since the late '70s, early '80s.

Damien McIntyre

Yeah, I suppose if you think of a pendulum, the pendulum swings wildly in one direction for a period of time, and then when there's change, the pendulum swings wildly in the other direction. The pace of that pendulum shift, you're right, was slow, and I think personally I was quite surprised it took that long for central banks to recognise that inflation was more ... there was persistency to it, and particularly once the war got off between Ukraine and Russia that was really only going to make things worse. So you're right. They were very slow out of the gates, and then when they swung, they swung viciously the other way, and now we're…

Stephen Miller

I'd actually maybe cast it a little bit differently. I thought they swung, but some of them, including the RBA, including the Bank of England, including the European Central Bank, seemed to swing ... almost needed to be coaxed into it, and let's not forget, the European Central Bank didn't end its pandemic era emergency settings until June.

And so why is European inflation at 10 or 11%? Now we know part of that is because of energy and what have you, and why are inflation expectations so large in Europe? It's because they were swung really reluctantly. Same with the Bank of England. It only swung tentatively. You had Andrew Bailey, the Governor of the Bank of England, tell a parliamentary committee that in May that it was almost out of his control, and for a senior central banker to say that I thought was be breathtaking, to be honest.

Damien McIntyre

Quite an extraordinary statement. Yeah.

Stephen Miller

I think that's a good question, and it's the $64,000 question, and I reckon if you'd asked me a month ago, I would've said, "I can't see any sign of it," but I think in the last month in a number of places, there have been just some straws in the wind that inflation has perhaps reached a turning point, and not only that, it might have tipped over.

Now there are a lot of caveats to this, but things are looking slightly better on the inflation front in the last month, and that's not ... mind you, that's relative to upwardly revised expectations from, say, six or nine months ago, but nevertheless, things are beginning to ... there are straws in the wind as I said, that things are looking a bit better for 2023, and you're seeing that in a change in central bank rhetoric.

So even last night, Chairman Powell made comments that suggested that the Fed was still going to keep increasing, but it's going to lower the increment. Instead of increasing 75 basis points, it's going to increase only 50, and later, maybe 25. The RBA's already stepped down, the ECB's likely to step down, the Bank of Canada stepped down.

There are these indications that, a, inflation has peaked, and b, central banks have noticed that, they're going to maybe just ease their foot off the brakes a bit.

The big question about inflation though is this. A lot of that moderation that we've seen in inflation has come from declines in goods prices, which we might have expected. Energy prices have declined, the price of second-hand cars have declined post the pandemic, supply chains are unblocking. That's all good news for inflation. What's a little more worrying is, when we look at services inflation ... and services, inflation is driven largely by wage increases if you like ... and services inflation hasn't shown signs of abating.

So whilst we might be a little bit confident that inflation has perhaps reached a turning point and is coming down, the big question for 2023, in my mind, is how fast services inflation comes down, and that'll determine how far overall inflation can come down, which will determine whether central banks can take their foot off the brake completely and pause their rate setting behaviour.

I think what's also important is that in the last quarter of this year, I think, financial market expectations and central bank expectations as to where they need to take the policy rate have converged. I think the other thing about 2022 is, not only were central banks behind in 2021, but so were markets, and then markets, I think they failed to take the central bank seriously when they did start to get serious, particularly the Fed. So markets were always lagging the Fed.

So I think in the last quarter or so, the Fed and markets are aligned in terms of their expectations as to where they need to take the policy rate, and so what that means is all the bad news for financial assets is in, because market expectations are finally caught up to where the Fed wants to take the policy rate, and indeed that's set up ... it makes it a surprise, if you like, symmetric again, whereas through much of 2022, markets kept being surprised at how far the Fed was going to take stuff. Now they might be surprised at how far the Fed takes it, but they're just as likely to be surprised as the Feds saying, "Well, we might take a break from things for a time and in fact, you know what, we might even think about cutting rates by year end."

So I think we've reached that period where all the bad news is in, and that increases the probability that we might finally get some sort of surprise in a new sense on the positive side.

Damien McIntyre

So just running with this thought. For every interest rate move north, there's a lag effect to the consumer. Consumers eventually have to adjust their spending habit in order to cope with, for the most of us, rising mortgage payments or other commits. What do you think about the prospect of recession in '23, and how do you feel about its severity?

Stephen Miller

Oh, yes, it’s a good question. I think when the Fed started using 75 basis point increments way back in, I think it was June or something, or even earlier, I think everyone thought, "That's it. A recession is almost certain."

I think what's also been interesting about 2022 is, despite the aggression the Fed has shown from just prior to the middle of this year, activity indicators have actually held in reasonably well, and that's not the say they'll always do it, because as you said, these things happen with a lag.

But after the first two quarters of the year registered slight negatives ... I'm talking about US growth here ... that doesn't necessarily define a recession in the US by the way, that's called by a body called the National Bureau of Economic Research, who use a variety of indicators and, as yet, they haven't said that the US economy's in recession.

The economy's actually been quite resilient, and the labour market's been quite resilient. The unemployment rate in the US is 3.7%. That's slightly off the 50 year low of 3.5%. Even here in Australia, the unemployment rate is 3.4%. The last time we saw an unemployment rate at that level, I think, was 1974, and so the economy's actually been quite resilient.

Now I would've thought ... and I think a lot of people thought ... that once the Fed did what it did, that's made a recession in 2023 a certainty, and indeed history would tell you that and, as we know, the most dangerous expression in investment markets is, "This time, it's different."

Having said that, if you look at history, every time the Fed has tightened to meet an inflation surge, and they've had to do it, and I think everyone, the consensus is that's the right thing to do. History will tell you that a recession almost inevitably follows. And as I say, the most dangerous words in financial markets are, "This time it's different."

What I'd also say is, it's very, very difficult, if we look at the data currently, to see that a recession is in the offering, because the economy, economies ... and I'd single out Europe and the UK here ... but the US, Canada, Australia, they've all been quite resilient and are not yet showing signs of recession. So I would say this. I'd say a recession probability ... I'd agree with Fed officials. I'd say that a recession probability is probably about 50/50, and I would say this too. I would expect that if we did have a recession, that it will be short and shallow.

And the other thing I'd do, and Chairman Powell, the Fed Chair, has made these comments that what the Fed could be pretty confident about is, if they do over tighten, and economy does appear to be slowing much, much quicker than they'd anticipated, and those lagged effects that you talk about are coming through, they know from their experience in the post-GFC period, and in the pandemic, that they have the tools to support the economy quickly if needed.

So yes, there might be a recession. Will the fallout for markets be that big? I suspect probably not. The only caveat I'd apply to that is, I'm not entirely convinced that expectations for earnings are priced in a recession, and so if we do get a recession and it is deep, then equity markets might fall further. As I say, because the Fed can reverse what it's done relatively quickly and support the economy relatively quickly, I can't think that that's only going to be short, sharp and episodic.

Damien McIntyre

Now I just want to ask you ... this question's a little bit off topic. Coming back to the bond market's reaction in the UK to Liz Truss's failed tax cuts promise. 10 year Gilt was what? 2% at the beginning of the month roughly, and 4%-

Stephen Miller

It sold over a hundred basis points in a month. Yeah, it wasn't quite ... I think it was about three to four basically, but four and a half…

Damien McIntyre

Yeah, well that was quite an aggressive move. Do you think perhaps we've reached the point now where bond markets are instructive to central banks and treasuries?

Stephen Miller

Oh, I think that's always been the case, Damien. Why would I think any different when I'm just an old bond market hack? You've always thought the bond market was the most important market and dictated the ways and means for the economy. I'll make a couple of comments on that.

First of all, there was no doubt that what Liz Truss did was an egregious error in policy terms. Her misfortune was to be the icing on a cake that had already been baked, which meant that the UK was headed for anything other than disaster if she persisted with the tax cuts and the energy subsidies, and two elements I'll refer to is, one, that the Bank of England was very, very slow in recognising ... slower than most others, indeed ... the persistence and magnitude of inflation. So they'd already made the gilt market nervous, anyway. The second thing is, Boris Johnson was distracted or ill-applied to ... not necessarily Brexit, but certainly its consequences ... and addressing particularly some of the inflationary consequences of Brexit.

So the cocktail was already potent, and then she came along and added a suite of patently inappropriate policies, and so the gilt market finally blew up and, as you said, force the government's hand, and forced them back to some more measured and sensible approach to particular challenges that the UK faces.

But your question is, is this a recognition that bond markets are dictating or providing some discipline on how policy makers react? I honestly think, without being flippant about it, I honestly think that's always the case.

When Bill Clinton came to power in 1992, and Alan Greenspan, the then Fed Chairman came over and had a little bit of a chat, the then young Bill Clinton, his reaction was, "So are you telling me that what I want to do is going to be contained by a bunch of ... expletive deleted ... bond traders?"

So even back in 1992, I think policy makers, incoming policy makers, were made aware that the bond market is the discipline on how far they can stretch ... or the discipline in over-egging the cake in terms of where they might want to take a certain of their programs, and that's only appropriate, because it's the bond market, I think, that in the end of the day, it's the credit rating agency, in an informal sense, for governments to make sure they don't spend too much, create too inflationary environment, to make what governments want to do unattainable.

So yes, you're right. It was the bond market that disciplined the Truss government and the UK government overall, but I think that's always been the case, and I use that Bill Clinton anecdote by way of an explanation to answer your question.

Damien McIntyre

But I'm also thinking, is this a cautionary tale, given the orgy of debt issuance right across the world exacerbated by COVID?

Stephen Miller

Yes, it is a cautionary tale, and it's saying that there is a limit to how far governments can go into debt, and how far central banks can run, and how fast central banks can run the printing press, because inevitably it will end in inflation, and I'll add this rider as well. My old professor, Charles Goodhart, and a colleague of his, Manoj Pradhan, have written a book which suggests that the disinflation that a number of us have been used to in the 30 years leading up to period prior to the pandemic, was driven by a number of structural features that started with the fall of the Berlin Wall, and that was things like globalisation ... the globalisation of the labour market, as not only labour markets were globalised from migrants from behind the old Berlin Wall, but also from China and India, so there was a lot of available labour globally.

And the other thing is, that was when we had peak baby boomer participation in the workforce, so in effect, we had a big negative wave shock that lasted about 30 years, that allowed this inflationary environment, allowed things like the emergence of what was called ... first the Greenspan put, but the central bank put, that because there was no inflation, if ever things got a little bit too ugly, the central banks could just open a spigot and rescue us all, so there was this central bank put.

When you've got inflation, the operation of that put is ruled out. So Goodhart is right, and that structural wage deflation shock is over, because baby boomers are retiring, the currents on globalisation are running the other way, the deregulatory agenda is certainly, as it attaches to goods, markets are running the other way, then we are embedding a bigger inflation bias in the system.

And so what that means is, the central bank put won't be able to operate as easily, so markets will be less relaxed from here on in about central banks adopting the sorts of emergency settings we saw during the pandemic. Markets will need to become cognisant of the fact that central bank put can't operate at least as easily as it operated through the '90s, into the 2000s, into the GFC and up to the pandemic.

Governments won't have the same, arguably, capacity to borrow, because bond markets will get choked, and I think part of the bond market selloff we've seen, stems from the fact that there was an aggressive expenditure program, one could argue necessarily in context, that started with actually Donald Trump and continued with Joe Biden, and arguably went too long, and it wasn't just in the US, it was everywhere, as we know.

And so there's a lot of bonds out there, and now also central banks are at the process of reversing QE or unorthodox monetary policy, so the central bank backstop in terms of the bond markets, not theirs, bond yields, they might well stabilise in 2023, but I don't think they're not going to go down to those sorts of levels that we saw in the period post GFC and leading up to the pandemic.

And bear in mind those sorts of yields that we saw…and I'll acknowledge that the data sources on this are a little bit problematic ... but they were as low as we'd seen for arguably 150 years. I've seen [inaudible 00:19:14] advisors put out a chart that shows that they were as low as they'd been for 150 years, so how could we expect yields like that to rally further, and they were inevitably going to head back to some normality. And part and parcel of that is visiting on not only governments but central banks, the limitations to fiscal policy and monetary policy.

Damien McIntyre

Question for you, and no one's talking about this, and it does fascinate me. So as yields have risen, or the price of risk has risen, over the course of the last 12 months, what impact do you think that might have on earnings, as companies who once gorged themselves on cheap debt? Or at some point, have to refinance at much higher levels.

Stephen Miller

Well, there's a number of facets to that question. It's often the case that cheap debt is no good anyway, because it allows zombie companies to persist, and that's not in anyone's interest because it just inhibits the structural flexibility of economies. So that's the first one. It's not a bad thing when bond yields rise and the price of risk rise, because it just means that the companies that shouldn't be around aren't around anymore. So that's the first thing.

The second thing is this. As bond yields rise, clearly equity valuations become more challenging, and that's part and parcel of what we've seen in 2022. The other thing is, as bond yields rise, it makes the P in the PE go lower, right?

And if the PE's going to stay the same, then the E follows, then the PE is stable. If it doesn't, then it's lower.

So we've seen the adjustment in the P. The big question, I think, for equity markets, as I've said, is do earnings expectations, corporate earnings expectations, now adequately reflect the probability that we are going to get a recession or, at least, a period of very soft growth through 2023? And I think that's the big question.

If you want to be glass half full, you can say yes, because as I said earlier, the US economy in particular, but also ... perhaps not UK, perhaps not Europe, but the US, maybe Australia, although I'm a bit mixed on that ... but the US has been very, very resilient, and there's some prospect that earnings expectations may not be that far from accurate, if as I said, we get us off landing and any recession is short and shallow, that might be okay.

So the increase in bond yields are seeing the P happen. If the increase in bond yields causes a recession and it's sharper than I think, then some of the E happens, and equity markets have got further downside in them.

So I think that's the way you square that circle, if that makes sense. I'm not sure I've explained that well, but there's three facets to it. Cheap debt kept zombie companies alive that shouldn't be there anyway, so no one's going to miss them. Higher bond yields mean that valuations are taken back to more acceptable levels. If higher bond yields have a substantial further impact on earnings, I think will be the key for 2023, rather than valuation metrics or price metrics being the issue, it'll be what happens to earnings and the impact of bond yields on earnings that counts in 2023. Whereas I think what we saw in 2022, was the impact of bond yields on price. I think that's by and large played out.

Damien McIntyre

So looking forward into '23, I'll make a bold statement and say that when inflation and rates peak, equities can follow. They can see the other side of the valley if you like, and that becomes the light on the hill. How do you feel about ... obviously this year's been a great year for inflation-linked bonds as well as variable contracts ... well relative to duration. How do you feel about duration now? Are you happy to take on duration risk?

Stephen Miller

I certainly feel a lot more comfortable now with beta risk, whether that's bond beta as reflected in the duration of various bond indices, or even equity beta. I feel more comfortable about that now because most of the tightening cycle in the US is behind us, and I think bond yields when they're ... they've gone through 4%, they're a little lower than that now ... but I think high yields around 4%, that looks reasonable value in an environment where there are, as I said at the start of this conversation, there is some straws in the wind that inflation may be peaking.

What I've not got my head around, is how quickly inflation can fall, and I think markets show up proclivity to be a little optimistic on that front. Having said that, I've been a little bit surprised by how quickly some of these recent inflation indicators are turned.

So to answer your question, do I feel more comfortable about bond beta and equity beta going into 2023? Clearly, yes. Big thump the table, yes. Does that mean that we can forget all the lessons of 2022, and just go back and set the portfolios at 60/40 and put our feet up and not worry about things? I think no, and I think that's the biggest lesson of 2022 is, we all were guilty about forgetting about diversification.

There are more things to a portfolio than equity beta and bond beta, and I think you've still got to retain that thought even in 2023, because there are still a fat tail of risks that attach to the environment in 2023, and so that means you do have to look at things like absolute return bond funds, long short equity funds, quant hedge funds, macro hedge funds. What we need to look around for are things that are not correlated with either equity beta or bond beta.

So bear in mind, up until 2022, everyone was comfortable with this notion that bond returns and equity returns were inversely correlated. That's fine, and that's been the case for the first two decades of the century. It wasn't the case for the last three and a half decades of the 20th century. So bond and equity, there's no immutable law about correlation between bond and equity returns, and I think that's the lesson we need to retain from 2022.

Even if we might get back to a bit more semblance of normality in terms of asset class performance in 2023, I think investors should take heed that first principle of investment, and that's diversification. Sure, have a bit of bond beta, have a bit of equity beta, feel more comfortable about it, but also diversify your portfolio into areas that aren't correlated with bond and equity beta as well.

Damien McIntyre

It's actually been quite interesting looking at the ... I'll call it the form guide or the league table, say the Mercer tables of managers through 2022. As we've got to the end, value's back, and value's back in a big way, so I think that this year has been a really difficult time for growth and in particular tech. So it wouldn't surprise me to see value strategies continue to go well in '23, on the basis that investors having been burnt in '22, will approach equities or approach beta with some caution.

Stephen Miller

Yeah. I was going to say, my comments on diversification also apply within asset classes. Don't load up with growth and tech, have a bit of defensive equity in there. Don't load up with defensive equity, have a bit of growth and tech in there, and I think that's the key lesson.

So I just talked about equity beta, but even within equities there are different styles, and sometimes we need a mix of defensive styles and let's call it growth styles, for an individual investor as part of their overall investment makeup. Diversification is, after all, the first lesson of investing. And I think the point you make is very good one, choose your growth manager, choose your value or your defensive equity manager, choose your absolute return bond manager, choose your beta manager. All those things are very, very important.

The only other thing I'd say about 2023 is, I do have some ... a lot of what I've said has been very US centric, and I fear that ... and if it happens in the US it means that it drags the rest of the world with it inevitably, in a financial market sense at least ... but the challenges being faced by Europe and the UK in particular, are very, very big, and in Australia we're in the middle. Our central bank has been less aggressive than most.

Now they might be proved correct, and notwithstanding some reasonable recent inflation indicators, I'm not convinced that they're going to persist, so it might be that there might be a few more challenges locally relative to the US in 2023, whereas I think locally there were less challenges relative to the US in 2022, and that's the other thing I think I might apply some thought to as an investor in 2023, "Has the RBA got it right and hasn't taken it as far as everyone else, or will it need to play catch up given wage developments we've seen in Australia?" That's the only other comment I'd make.

Damien McIntyre

Well, yeah. Well the RBA has really been on the run. They've been under pressure from coming to the party late. Even though they've woken up eventually, their implementation has put them under pressure, so it'll be interesting to see how that plays out for us through next year.

Stephen Miller

Now having said that, they may well be right, but I think the risks for challenging financial markets is maybe greater locally in 2023 than it is in the US, whereas I'd say the risks of 2022 ended up being more challenging in the US than elsewhere. How I'd characterise it is, the Fed have done a good job by getting aggressive and almost vanquishing inflation ... well, not vanquishing, but we've seen some light at the end of the tunnel in terms of inflation, which may reap dividends in 2023. I think that's a little bit more arguable when it comes to the local scene.

Damien McIntyre

Yeah, I agree. Well, thank you, Stephen, for a interesting conversation again. I'm not sure what the timetable is for '23, but no doubt you're on the playlist, so your name will come back up again, and I look ... all I'll say is I hope you have a great Christmas and I look forward to chatting with you again in this format next year.

Stephen Miller

Great. I'd look forward to it, and the same for you and everyone listening.

Damien McIntyre

Thank you very much. And ladies and gentlemen, we might just wrap things up here by saying thank you very much for your support of GSFM over the last 12 months, and on behalf of myself and everyone at the firm, just want to wish you a great Christmas and a much better 2023. Thank you.