Hello and welcome to the first episode of Conversations for 2024. This year's podcast will take us back to basics, a deep dive into each of the strategies through conversation with the investment specialist responsible for each. The first two episodes will set the groundwork for 2024 by taking a look at the domestic and global macro environment and how that's likely to impact investors. Today's conversation sees GSFMs, investment strategist Steven Miller, in conversation with our CEO Damien McIntyre. Steve will share his perspective on the macroeconomic themes impacting Australia and the rest of the world and the investment environment as we look forward into 2024.

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

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Damo and Steve, the floor is yours.

Damien McIntyre

Thank you very much Tracey and I trust you had an enjoyable Christmas and summer break and great to have you with us again this year.

Same to you, Steve. Welcome.

I think having macro discussions early in the year is timely for everyone, because I think we're starting the new year and we're really trying to focus on what matters for us, for both our client portfolios and how we frame our views of the market. So it's great to have you with us, Steve, looking at macro picture initially in Australia and then expanding out globally. Just by way of background, Steve has had pretty much all of his career working in bond markets either on the sell side. Steve even worked in United States selling Australian bonds to US investors and then came back and was managing Australian bond portfolios at BT and then later went on to be head of fixed income at BlackRock.

So Steve's had a career thinking and investing in bonds for the best part of three or four decades. So great to pick your brain on what's ahead. Perhaps it's worthwhile starting with just this conundrum of where we are in the inflation interest rates cycle, Steve. Perhaps we could start with Australia, because we seem to be getting mixed messages.

On the one hand, inflation seems to be quite sticky, but on the other hand, in recent weeks we've seen Godfreys, for example, end up in administration. Godfreys has been selling vacuum cleaners pretty much for all of my life that I can remember, and then also unemployment sort of seemed to tick a bit higher in the last week or so. So where do you think we are and what do you think is likely to unfold?

Stephen Miller

It's a good question. Look, I do think it seems pretty clear that economic growth or economic activity is proceeding at a pretty tepid pace, and you referred to those employment numbers last week, which did, I think unambiguously, show that the labour market is softening. And it might be that the unemployment rate, which I think the RBA forecast is for 4.2 by June, we're already at 4.1. Now, one thing I will say is that interpretation of statistics at this time of year is very, very difficult, because the seasonal adjustment process has probably changed and there were some elements of that recent labour force report, which I think means that we can reasonably anticipate there might be some sort of offsetting strength in February when those numbers are issued in early March. So I think yes, the local economy is soft. Pointed to Godfrey's retail sales has been weak and the labour market looks to be softening.

However, it's also true that inflation has been sticky, and I think this reflects a couple of things. One is the RBA were very late out of the barrier in trying to contain inflation, and the longer you let it get away, the harder it is to bring back. I think that's the first element. By the way, the RBA weren't the only central bank that was late out of the barrier to tackle inflation. I think that's true of almost every other central bank.

And the second is there are some particular elements that work in Australia that mean that the task of getting inflation down here might be even harder, even with weaker economic activity. And in particular what I'm referring to there is what has distinguished Australia and maybe one or two other places is we've had very, very low productivity growth. So to the extent we've had low productivity growth that makes inflation stickier, it's all right to have 4, 5, 6% wage growth if productivity is sort of growing strongly. It's not all right to have 4-5% wage growth when productivity's going backwards, and that's been the problem that we've had in Australia.

That means unit labour costs, the amount of labour costs takes to produce one unit of output in the last national accounts, which admittedly were back in September, had been growing at 6.5%. And unless and until productivity recovers, it's going to be very, very difficult to get that rate of unit labour costs growth down and that rate therefore and that rate, the current rate of inflation, down. That's the first point I want to make.

The other point is there have been sort of changes to the industrial relations and wage setting framework in Australia. Now obviously they're well-intentioned, but they're not in general helpful when it comes to exciting any sort of productivity growth in Australia. So again, that's a domestic reason why inflation may be stickier. So that's Australia. As I say, there are some particular domestic reasons that mean inflation's higher even with weaker economic activity.

But I think it's more important too, just as important to acknowledge what's happening in the United States. There was a couple of price indicators out there last week, the CPI and the PPI. Now the PPI is important, because that feeds into the Fed's favoured inflation measure, the core private consumption expenditures deflated. I think that too emphasised how difficult and how sticky inflation is. Rather than immaculate and smooth, the process of disinflation tends to be a little bit more disjointed. It's sort of two steps forward and one step back and you'll hear a lot of central bankers talk about the so-called last mile to the inflation target proving particularly challenging. And the sort of numbers we got out of the US last week, just got to emphasise that and there are good reasons for that.

You referred to my, I guess longevity or probably old age is another term for it in terms of my experience in the bond market, but I think recently or what we've seen in three decades, probably from the '90s into the first two decades of the 21st century, there were structural elements at work that served to suppress inflation and they're in the process now of being reversed. So the globalisation of labour supply after the fall of the Berlin Wall and the export of labour from large emerging market economies such as China and India, that's abating. Globalisation of goods markets is in retreat, because as governments everywhere in induce protectionist measures under the guise of industrial policy and national champions, domestic regulation of goods and labour markets is increasing in scope. Now again, that might be well-intentioned, and it might serve a purpose, but the reality is that means inflation is stickier and harder to get down.

And finally baby boomer workforce participation is declining and that's limiting labour supply and lifting wages. So they're the global influences on keeping inflation high.

Just as the US faces a challenge in getting inflation down, so does Australia face a challenge in getting down, and it's probably true in most other developed economies as well. Where the US might be a little different is economic activity there looks to be a bit more resilient than say it looks to be here in Australia or in Europe or in the UK, which officially went to recession last week or in say Japan, which also went to recession last week, and China, which has had some sort of well-documented headwinds that are confronting its economy.

So the answer to your question is this, Damien, inflation is going to be hard to get down even with softer economic activity. I think we'll get there. I think what we can say is central banks have probably stopped increasing rates, but it might take a little longer before they start reducing them the markets probably thought at the start of this year. So for example, markets had the fed, I think cutting rates by 150 basis points in January. That's been wound back to 90 and that compares with the fed's own expectation of 75. Markets here too should have almost had two leaning towards three rate cuts priced for 2024. That's probably in the process of being dialled back. Yes, there's no more rate increases, rate cuts are coming, but they're probably not coming as quick and with the same orders of magnitude that markets may have anticipated when we first turned into 2024.

Damien McIntyre

Thank you. Can we just step back to the industrial law changes we've seen in Australia announced in the last week or so. Personally, I was particularly surprised to see some of the changes that were mooted. For example, the bosses not being able to contact their employees after a certain time of the day. What struck me the most just in, and I don't intend this to be a political statement, Chalmers, it's early days in his career as a treasurer. He seems to have some talent and he seems to be a thoughtful man. Given that productivity growth is vital for any vibrant economy, it seems that some of these industrial changes fly in the face of that and will only make it harder to achieve productivity gains. Did you think much the same thing or how did you react to those when you saw them?

Stephen Miller

Well, to be fair to Jim Chalmers, they weren't his laws, they were Tony Burke's.

Damien McIntyre

The cabinet would discuss these though.

Stephen Miller

Well, of course, of course they do. I think you're right. I suspect Jim Chalmers knows what the right thing to do is, it's just that he has difficulty making those big reform changes that perhaps characterise previous governments, particularly the Hawke-Keating labour government where there was lots of economic reform, helpful economic reform, which I think sort of set Australia up for an extended period of prosperity. I think Chalmers presents well, but if we judge him by what he's achieved, I think the cupboard looks slightly bare and there are reasons for that.

Some people might say that the current government doesn't have a mandate to implement those reforms. They didn't take them to the last election, so they don't have a mandate to do it and therefore that's why they've sort of restricted themselves to very modest ambitions on the economic front during this term. The industrial relations changes notwithstanding, but at the end of the day, you're right, Damien, these industrial relations changes, they might be well-intentioned, they're always well-intentioned.

I don't think anyone wants to act as a maligned sort of agent in these things, but there are costs which arguably outweigh the benefits and the big cost of those IR changes is they're inimical to productivity growth and being inimical to productivity growth, they will make inflation stickier and that's just the reality. I suspect Jim Chalmers knows that and in that sense it might've been a little remiss of him not to sort modifications to those proposals. Who knows, he may well have done. That's the reality that politicians on both sides these days seem less willing to lead in the mould of Hawke and Keating and perhaps John Howard. These days they react to public opinion rather than lead public opinion and that's true not just in Australia, that's true almost everywhere.

Damien McIntyre

We live in an era of populism and-

Stephen Miller

Again, that's not to say that the government's done a bad job or Jim Chalmers has done a bad job, but it's a long way from saying they haven't done a... There's a difference between saying they haven't done a bad job and they're doing an excellent job, and I don't think we can sustain an argument around the latter.

Damien McIntyre

Yeah, well hence my remark about it. It's early days for Chalmers. There's a lot of rubber, so he could still hit the road. Now, if we could just move on to global growth, and again, we're in this challenging time. The IMF is talking about soft landings during the course of '24, yet recently as we've seen the UK has slipped into recession. Japan, which I still think is that the third-largest economy in the world, it went into recession last week.

Stephen Miller

That was a bit of a surprise actually. I think that caught a lot of people in the market by surprise. No one saw the Japanese recession coming. I think they suspected it was happening in the UK, but certainly not in Japan.

Damien McIntyre

Yeah, and that also cascades down through Asia as well.

Stephen Miller

Well, particularly with China, as I said earlier, facing some vast economic headwinds.

Damien McIntyre

So in an election year, I mean one would then assume that the batons of global growth have to be carried by Western Europe and-

Stephen Miller

Well, that's not going to happen.

Damien McIntyre

Well, that leaves the US in an election year.

Stephen Miller

I think a soft landing is deservedly the most likely scenario for the US. Now in saying it's the most likely scenario, that doesn't mean there aren't risks that go both ways. We've already talked about sticky inflation. The other one is we've been constantly alert for the last two or three years is a recession. Now, at the moment that doesn't look likely in the US. As I say, the soft landing seems to be the most likely scenario. There are key risks to that scenario. We can't rule out a recession in the US either. That narrative goes, well, the reason that the US economy is sort of surprised, if you like, on the upside with its resilience, is that that may have been the result of a US fiscal sugar hit.

What people forget in the US is that the budget deficit there is 7% of GDP at a time in the economy there is pretty close to full employment. Now that's not a desirable circumstance to be in. When you're close to full employment you shouldn't be running any budget deficit, let alone one that's 7% of GDP, which is very, very high historically.

As you say, this is an election year. It's harder to see the budget deficit get bigger this year, which might mean that there is some fiscal contraction and that some of the ongoing impact of monetary tightening in '22 and '23 might need to be withdrawn. So that's the other risk scenario. So you've got soft landing, but the risks are on the one hand stickier inflation and on the other that there's a recession. Now, if you asked me to put indicative probabilities on those, I'd say the soft landing's about a 40% case. The sticky inflation's probably about a 25, the recession's probably about a 25 and stagflation is probably about 10.

So there's a lot that can go wrong with I guess the central scenario, which is the point that I'm seeking to make. You mentioned elections. We've just confined our comments thus far to the economic outlook, but if we look at geopolitical risk, and you've got the US presidential elections this year and everyone knows just how febrile the US political landscape is.

We've got EU elections this year. The rise of the populist right in Europe may well be manifest in the results of those elections in the midyear. This includes Marie Le Pen in France, the AFD in Germany, the Dutch elections late last year, the populist far right parties got the most seats, but there's a lot of risks around politics and elections. And then we've got the Middle East, we've got Russia/Ukraine, we've got China/Taiwan, and we've got the Korean peninsula.

There's a lot to be worried about even if the macro soft landing looks the most likely.

So these things are all sort of worth considering and I haven't even gone to some structural elements, which I think are just as important too. I talk about structural sticky inflation, but the other thing I think is worth bearing in mind is that I think there's a higher neutral interest rate now. The resilience of activity in the labour market during the recent fed tightening cycle suggested that the notion that the natural real growth rate has increased and that the neutral real interest rates should have increased.

I've talked about the US budget deficit. There's huge demands on savings pulled from clean energy investments coming and I've mentioned in the context of while inflation sticky that baby boomers workforce participation is declining and they're drawing down their savings. So all of those things might push neutral interest rates up. That doesn't mean they won't fall from here, but they might not fall that fast. So there's those macro issues, there's those geopolitical issues and there's those structural issues that might upset that sort of fairly benign soft landing outlook that we've got for the US and by extension elsewhere, even if elsewhere growth looks a lot more challenged than it might do in the US.

Damien McIntyre

Just coming to interest rates and central bank activity. Where we are now, the market is anticipating rate cuts from central banks here and most notably or the US gets all the attention.

Stephen Miller

And in Europe and in the UK, and I think that's the right expectation. I'm just not sure it's going to be as far and as fast as the markets, certainly as the markets had it back in January.

Damien McIntyre

Yeah. What I was going to ask you is, it's more likely they'll occur sooner. Europe will most likely be the first card to fall given their growth profile is weakening faster than the US is anyway. So I suppose in general context, to what extent do you think that any reduction in rates, I know they'll be good for financial assets, but how do you think that plays out through the real economy?

Stephen Miller

In the conventional way. I mean, it'll help. I think what we want to remind ourselves is that those interest rate reductions occur, because growth looks particularly weak. So what it might mean, and if inflation stays sticky, they might not occur, as I keep saying, with the same pace that markets anticipate.

So even if they do fall, they might not fall that much, which means the economy may take its time to recover and we do get very, very tepid growth in these places and their cyclical downgrades to earnings and well bond markets might do okay or even well. Depending upon the cyclical hit to earnings expectations, equities might not do anywhere near as well. Now again, there's sort of the US and then there's elsewhere, because the US actually looks okay at the moment and it's elsewhere where the problems seem to be manifesting themselves. There's a lot of things there to think about.

I think the other thing that we, and I'm sure some of your other speakers will engage with this topic, but there's some pretty big mega forces out there impacting on equity markets too just away from the economic cycle. Decarbonisation is a big one and how that sort of plays out. And the other one is obviously AI. These are big mega themes permeating through equity markets, particularly in the US, that a) mean the cycle is one thing, but these structural elements are another, and b) because they tend to be fairly US centric, they're going to have an outsize impact on the US equity markets where already the macroeconomy looks in better health than they might do elsewhere, UK, Japan, Australia, places like that.

Damien McIntyre

Yeah, it's quite interesting. You mentioned one of the global megatrends is the energy transition. For a period of time it was very manifestly obvious in commodity markets, in particular lithium prices, cobalt prices, nickel prices. And what we've seen in the last year is a collapse. I suppose it comes back to my question is, how long is it realistic to draw the conclusion that the way markets would once respond with a demand stimulus, are we all get too excited too early and-

Stephen Miller

No, no. Look, I think it will respond to a demand stimulus. It will respond to a monetary stimulus. It might just take time. That's not going to happen overnight. These things never do. I do vaguely remember my undergraduate years, Damien, even though it was, as you said in your introduction, a long, long, long time ago, decades I think you said. But I remember in my undergraduate economics course we were taught that the lags with which monetary policy operates are long and variable and I think it just pays to sometimes bear that in mind. Now markets can be forward-looking, we know that, but sometimes a rectification, particularly after an inflation shock can take a lot longer than markets might have otherwise anticipated. I think one of the famous economists of all time, John Maynard Keynes, I think Milton Friedman told us that the lags in monetary policy are long and variable.

John Maynard Keynes once said that the markets can stay irrational longer than you can stay liquid. So these things are cute expressions. But every now and then I think we need to sort bear in mind those things when we are thinking about investing and all the things that we've canvased this year. I mean I think there's a couple of elements, basic lessons in investment that we all know, but we should all remember that when you've got a lot of uncertainty and we've gone through macro uncertainties, we've gone through geopolitical and political uncertainties and structural uncertainties, when you've got that many uncertainties, you can potentially get seismic shifts in sentiments and seismic shifts in the prices of financial assets even if the soft landing benign scenario does play out. And that just reemphasises a couple of things for me. One is the principle of diversification, which is the first lesson of investing.

I think the other thing it throws up is it possibly increases the potential for return from skilled active managers. High volatility typically leads to a greater dispersion of returns of individual issuers of stocks or bonds. Those mega forces that we spoke about climate or decarbonization and AI are likely to accentuate that. And even sort of more mundane elements, housing shortages, particularly here in Australia, we hear a lot about that, same in the UK. Strains on health systems from aging populations. These things mean that the potential for return from skilled active managers could be potentially higher in a higher volatility environment and it might be useful.

Obviously you've got to do your work to sort of search out a skilled active manager, but it might well be worth your while doing that sort of research, finding a good skilled act manager to manage your equities and even your bonds. In terms of diversification, most bonds and equities are always going to be the foundation stones of your portfolio or bond and equity beta. It's worthwhile looking for the sources of return uncorrelated with the returns of the bond market or the returns from the equity market. And I think there they're the sort of important considerations to bear in mind given the sorts of discussions that we've had about what are the big issues out there for markets in 2024.

Damien McIntyre

All right, winding the hands of time back to your days as the analyst and then later the portfolio manager, if you were running a bond portfolio today, how would you be thinking about positioning it? What would you be anticipating?

Stephen Miller

I'll answer that this way. I've got a different career now and that's managing the family self-managed super fund. I have to report to the investment committee in terms of my wife about how that sort of self-managed super fund's doing and what I'm doing in it. What I will say is in the last three or four months, for the first time in about five or six years, I've bought some bonds. And the reason I've bought some bonds is I think a) we've had the yield back up and b) we have got to a stage now where bond yields are pretty attractive. Central banks have probably finished the process of raising the policy rate, even if it might take more time to embark on the downward journey in policy rates. And that means your chances of any capital loss from holding a well-diversified bond portfolio are probably smaller than they have been for some time.

So it's a good time to sort of look at some bond exposure. You're not going to get rich investing in bonds at 4%, but what will happen is if there is a big accident and if there is a big accident on the downside, we know that what the central banks can do now that inflation is if only coming down, if only slowly, they can respond to that, they can respond with rate cuts, and they're basically told us they're going to do it this year.

I think we can sort of see bonds reassuming in 2024, their traditional role in a multi-asset portfolio, in other words as a good safe harbor type investment compared to riskier equities. And in saying that, that's not necessarily because I'm negative on equity markets, I'm not particularly, but so what I'm saying is that we can have meaningful foundations of a portfolio.

Bonds are back, you always have your weightings to equities but also have your multi-asset portfolio, those sources of return uncorrelated with bond or equity beta. I like bonds because they're okay. They're not going to make you rich, but you're not going to lose much money from them. Equities are okay, but we know they're risky and we know there's lots of challenges out there.

And I wouldn't forget those other elements that I talked about, investments that are uncorrelated with bond and equity beta. So what do I mean by that? I guess, I mean I wouldn't forget those things I talked about in terms of sources of return uncorrelated with bond and equity beta, so long short liquid alternatives, macro or quant hedge funds. With your bond exposure, you might want to sort of think about things like linking up a sovereign bond fund, so a very high quality government bond fund and combining that with say, a private credit fund where you can get some very attractive type returns, including here in Australia as we know with one of our partner managers Tanarra Capital Partners.

So they're the sorts of things that I'd be looking at in terms of putting my portfolio together. A foundation of bonds and equities, so let's call that 40 and 30, and then about 30% to other things. As I said, long, short, liquid alternatives, macro quant hedge funds, you might want to include gold in that. You could probably include private credit, you could probably include private equity even. I guess if you're really adventurous and I want to emphasise, I do not have any of this in my portfolio, but if you're really adventurous, you might want to have a very small crypto exposure. But that's not something that I'm putting in my self-managed super fund.

So I hope I've answered your question in terms of how I've positioned my portfolio. I've upped my bond weight from nothing to something close to 30%. I've got my growth assets sort of equities close to 40%, and I've got those other little bits and pieces, they're around about 30%. And that's the way I'm thinking of managing a multi-asset portfolio. So that way I'm sort of diversified at a very high level. And underneath that, I'm also quite well diversified. I've got a mix of passive ETFs and active managers with my equity portfolio as I mentioned earlier.

Damien McIntyre

Well, thank you very much, Steve. I think it might be time to wind the conversation up given that you are in the middle of a storm as we speak. And thankfully it's not the financial markets that are blowing up around you.

Stephen Miller

Let's hope that it stays that way. But as we know, inevitably there's accidents in financial markets and I suspect we'll have episodes of that this year. As I say, I think it's important to bear in mind that the soft landing case is the central case, but there's a lot that can go wrong with that.

Damien McIntyre

So don't be afraid of bonds. Don't be afraid of duration.

Stephen Miller

No, I mean, yeah, who wanted to own a bond when the 10-year yield was less than 1%? No one.

Who would've owned a bond when inflation was rising rapidly, and central banks were behind the curve in attacking it? No one in their right mind.

Now we're at a circumstance where central banks are finished tightening, economies are slowing, inflation is coming down, albeit in, as I say, a disjointed and two steps forward, one step back way. And in that environment, I think bonds are going to have a better year in 2024 than they have in the preceding three.

Damien McIntyre

I certainly agree with you. Steve, thank you very much for your time and I look forward to reviewing our bold predictions later on in the year.

Stephen Miller

Okay. All right, that might be interesting!

Damien McIntyre

Thank you.

Stephen Miller

Okay, see you.