Hello and welcome to the second episode of Conversations for 2024. This year’s podcast will take us ‘back to basics’, a deep dive into each of our products through conversation with the investment specialist responsible for each.

For this second episode we welcome Kevin Hebner, global investment strategist with TD Epoch. Together, he and CEO Damien McIntyre will discuss the global macro environment and the investment themes most likely to impact investors in 2024 and beyond.

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

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Damo and Kevin, over to you.

Damien McIntyre

Thank you very much Tracey for that warm introduction. Kevin, welcome to Australia and welcome to our podcast.

Kevin Hebner

Thank you very much, Damien.

Damien McIntyre

By way of background, our Australian clients are very familiar with Bill Priest, Kera Van Valen and John Tobin, but they're yet to meet you, Kevin, so I wonder if you'd be kind enough just to very quickly give us a quick snapshot of your background and your role at Epoch?

Kevin Hebner

Okay, thanks Damien. I've been at Epoch for eight years now. I did previously work with Bill Priest at Credit Suisse. This was a couple of decades ago, and actually, both John Tobin and Kera, were at Credit Suisse at the same time as well. I started off my career at the Bank of Japan in the mid-90s and spent about 13 years working in Japan after the BOJ, I was with UBS as Japan equity strategist and then Credit Suisse. Afterwards, I spent time on the trading floor at JP Morgan in New York, so the main fixed income in FX trading floor, which it's very good to spend some time on trading floors and see how the fast-paced, short-term world works. I think it's especially good to do that when you're in your 20s, not when you're in your 50s.

So I moved to Epoch about eight years ago and I'm very happy to be working with Bill Priest, John Tobin, Kera and quite a few friends that I've known for a long time. It's a very good group, focused on free cash flow, shareholder yield and I think all the right things.

Damien McIntyre

Similarly, my first job out of university was actually working on the floor of the Melbourne Stock Exchange. So yes, I can certainly agree with you wholeheartedly that those jobs are great in terms of the action, but equally, very well-suited to someone young rather than someone of my vintage. So thanks for that and welcome.

What I might do is just fire a heap of questions at you and pick your brains and share your insights with our audience. So if I could just start with interest rates and inflation. Both rates and inflation have dominated the markets for the best part of two years now, or interest rates have dominated the markets for a lot longer period for being much lower than they are today. But obviously, when inflation raised its head in Q1 of '22, that sent the interest rate markets north very, very quickly. So in your view, so where are we now and how do you think this will play out over 2024 from an inflation and rates point of view?

Kevin Hebner

Starting off with rates and say real yields, we've seen this ratcheting down. The real 10-year yield, for example in the US averaged 5% in the 80s. That moved down to 4% in the 90s, 2.5% in the 2000s, just above 0% in the 2010s. And that was supposed to be the new normal. In fact, it was the new abnormal. And what we're seeing more this decade, for a number of reasons I think, is real yield starting to normalise and we think the average for this decade will be a number closer to 1.5% to 2%. In terms of economic theory, the real yield is supposed to be similar to potential real GDP growth, which is probably a number like 1.8%. That hasn't been true for a long time as we've had this downward trend since the 80s after a pretty brutal 1970s.

So real yields, we see much higher than last decade. So a number somewhere in the 1.5% to 2% category. In terms of inflation in the United States, we focus on core personal consumption expenditure prices, so core PCE inflation. And if you look at the three-month change or six-month change in that number annualised, it's already around 2% and there's a number of funky things going on, particularly with shelter in inflation measures that might lift it a little bit short-term. So we see inflation two to 2.5% for the next quarter or two, but we are close to target, and I think for a number of reasons inflation's going to be secularly higher than it had been last decade in the decade before. But I think to large extent inflation has normalised. It's still a bit too early for the Fed to take a victory lap, but probably looking at our first cut in mid-June, three cuts this year, then I think trying to look beyond a year, because if you think of the track record of macro-forecasters over the last four year, every year we've had strong views every year people have been totally wrong.

So I think one has to be quite humble in how you view the outlook and also willing to change as the data comes in differently. And we've got a lot of events this year, so I'm sure the macro-perspective is going to change pretty dramatically from how we envision it January, February this year to what we're seeing by end of year.

Damien McIntyre

Interesting. Now tell me, the US market has been really quite resilient. I know if we're looking at the equity market, particularly the strength in the market has been around this new phenomenon of the sensational seven or the fabulous seven or whatever the description is. Given the US equity market's strength over the last year or so, how do you account for that? How would you explain it?

Kevin Hebner

So it has very much been driven by the magnificent seven. So seven supposed AI plays. And so for example, if you look at consensus expectations for earnings growth this year for the entire S&P, it's 12%, but for 493 companies it's 5%, roughly in line with nominal GDP growth. For the mag seven, it's 55%. So we've got this enormous dichotomy and that's really being driven by the build out of the infrastructure for AI, all the picks and shovels, so the compute, the clouds, semiconductors, and that's all different levels of the stack. And so that's going to drive earnings certainly through 2024 into 2025. But I think beyond them we get a real problem, and we have to say, well, how is AI actually adding values for consumers, households, and business people? And that's not at all clear. And usually when we have new technologies like this, it is a decade-plus long process.

So it looks like this trend might continue through '24, but beyond that, I think people are going to be a bit disappointed by the length of time it takes that it always takes for disruptive technologies, in this case AI to actually add economic value to businesses and households.

Damien McIntyre

Well, it's interesting, I suppose when we look back through history and we look back through time, there has been quantum shifts in commerce or technology, which really has been the catalyst for these big market moves. So it's probably fair to assume that the markets are anticipating significant and lasting change as a result of AI. And I suppose that's why these AI leaders have been so dominant.

Kevin Hebner

Yes, and I guess the issue is well, how much is priced in and is that reasonable? So for example, with Nvidia, we think it's priced in 20% earnings growth for the next 18 years. Now companies have done that before, but there's never been a case that a huge company has done that before. So previously, much earlier Apple's done that, Microsoft's done that, lots of companies have done it, but never a huge company. So we think it's possible, but it's quite improbable.

And so to more broadly looking at the mag seven, there's three reasons to think we might be in some type of bubble, similar to a bubble like we had in the late nineties. One would be the enormous concentration in terms of stock market cap for small number of stocks. The second is valuations, which is extreme. And then thirdly, I think the euphoria of so much public comment, the things that pundits are saying, and all three of these sound very much like the 1990s. And then the question is, is today 1999 or is it 1997? And clearly the implications for investors are pretty important, which one you think it is.

Damien McIntyre

Yeah, we're in an amazing moment in time, particularly as it applies to Nvidia. I was looking at Bloomberg last night and there was an article and headline which was, "The world hangs on NVIDIA's results." And I thought, "My God, is this what we've become?" That one name is going to be either a lightning rod for volatility or a drawdown, or secondly, if the numbers are better than expected, do we breathe a sigh of relief and life can go back to normal? It's quite extraordinary really, this moment in time and in particular the magnificent seven.

Kevin Hebner

So Nvidia will report today, today's Wednesday. And so it is important, because Nvidia very much is the centre of the build out. We've seen the compute that's dedicated to AI increase 10X every year for the last decade and are probably continue increasing 5X or 10X for quite a while. And given the lock-hold that Nvidia has in this ecosystem, it should be good for Nvidia. And so the market will be looking this number for what it means for Nvidia at a very elevated multiple, but also what it means broadly for the build out of AI infrastructure and all the names attached to that. And so if we see a slowdown in NVIDIA's numbers, that means the entire buildup is slowing down, then I think we could see a pretty marked sell off. But my feeling is the infrastructure still is quite a way to build up.

My guess is throughout this year it remains pretty strong, but not a whole lot beyond this year. At some point we really do need to see the killer apps and how AI isn't just benefiting picks and shovels and the infrastructure of digital tech, but actually we need to see real services that are benefiting goods and businesses and households. And we've seen a lot of cool stuff, but not stuff that really is going to move the needle that way. In that way it feels a bit like '99, like in '99, the businesses that we're doing well we're all really good businesses. It was just way too early. And patience is not something that the stock market is always terrific at.

Damien McIntyre

Yeah, we still haven't learned that from history, have we? You're right. Everyone tried to imagine the internet and how it would change our lives in the late nineties, but it didn't really have a significant impact for many, many years later. And the NASDAQ as back then it got there way in advance of the actual change, led to some disappointments and tears during the NASDAQ's correction in the early part of the year. Oh, so you're right, it's fascinating and it really will be interesting to see how this all plays out.

Kevin Hebner

Yeah, the one major difference between now in the nineties, is the tech leaders now are producing a lot of free cash flow, pretty terrific operating margins and the return on invested capital relative to the cost of capital, it's very nice. And that's different than the late nineties when most companies were burning through cash. So that's an important difference, even if there's the three similarities that we mentioned before, but still there's a question we're embedding so much earnings growth and it's normal when you have a new technology that you overestimate the short-term impact, you underestimate the long term impact. But we're in the short-term right now. And so we do think that there is going to be this point when you look over the chasm and the market does have to retrench for a while, even if what's going on is real and it's important. I think what's been priced in is moving well-ahead of what the technology's going to deliver.

Damien McIntyre

Just on AI, and I might get you to indulge us in a little bit of AI for dummies. I mean, I get how AI is omnipresent. And for example, if I were to search on Google for a new car, miraculously every advertisement that seems to present itself on my screen for days afterwards, a new car ads from either manufacturers or car yards. So that's sort of one sneaky way this all plays out. How else do you think it'll manifest itself and what sort of benefits do you see for commerce and indeed the consumer?

Kevin Hebner

So far, say the experience from '23, there's two places where AI's move the needle. One is for software engineers writing code. So Microsoft co-pilot can make them 55% faster. So that's real, and it's happening and that's pretty important. The second place has been writing marketing copy. And in fact, that's the number one use so far of generative AI. But there's many different places, example, bringing AI into call centres to help those workers. That seems to result in a bump in productivity of 15%. A majority of radiologists now are using AI to enhance what they do. Taxi drivers are using AI, help them find where to go, where they're most likely to find the next rider. And there's a lot of potential applications and applications that are being rolled out in the medical sector, in the education sector. And we think this stuff is very exciting, it's going to make the world better. It's just that when you move from the world of bits to the world of atoms and then you run into institutions and power centres as you do in healthcare and education, just the rollout takes a lot longer than people think.

Damien McIntyre

Talking about tangible productivity benefits. I had a series of board meetings for my involvements here in Australia this week, and one of them was 156-page board pack, and I was moaning about how much I had to read on the weekend, and my 17-year-old daughter suggested that I take a photo of each page, put it into the Microsoft, whatever that package is, and within, hey, presto, within a few minutes, this Microsoft package will give me a summary of the key points from the 156-page board pack. And I looked at her quizzically thinking, well, I sincerely hope that's not the way you intend to educate yourself or buck the system moving forward. And I want to stress for all our listeners and clients' benefit, I didn't cheat. I did read every 156 pages, but as you say, in terms of the speed and productivity gains, these things can generate. It's scary, isn't it?

Kevin Hebner

I don't think it's scary. I think it's very promising. It augments our abilities, it's going to make us better. If we're analysts or portfolio managers or strategists involved in the finance world or education or healthcare, Steve Jobs used to always say computers are bicycles for the mind. So this is what we have with AI. Maybe it's a motorcycle for the mind, it's something for the mind. It definitely makes us better. In terms of your daughter's example, that's a terrific one and that's used a lot. So when people get a complicated paper, you need to read through and say, you don't have three hours, you take the PDF, you put it into an app and then say, can you give me a 200-word or 400-word summary and it'll spit out, and then you understand what the paper's about, and then you can decide, okay, is this worth spending three hours on or not?

Similar, if you have to write something on a topic, you're not really sure how to structure where to get started. So you say to it, I need to write a paper, for example, the pros and cons of investing in India. Can you give me 600 words or 800 words? And it'll give you that and it'll give you a structure. And some of it will be wrong, some of them will be pretty average, but it saves you quite a bit of time as a writer, and that's going to get better and better. So AI, artificial intelligence really about augmenting intelligence, augmenting your ability. And so people in creative fields and white collar fields, it's more than a bicycle for the mine. I'm not quite sure what the right metaphor is, but we should, in fact, we definitely should not be scared of it. We need to embrace it in the same way that we needed to PCs and the internet and how they would help us do our job even better.

Damien McIntyre

Yes, yes, indeed. Now, if I could just switch back to, or change gears and just talk about the world and in the context of 2024, it really is a big year for elections. We've just seen put it this way, China got the wrong answer in Taiwan, it was a government that's friendly to maintaining Taiwan's independence, but we've also got elections in many other jurisdictions and most notably perhaps the United States. So how do you think this in particular the US, because that's your home, but having worked in Japan, you've got a better understanding of the region than most Americans. What do you think will happen to markets and through the year with this election cycle?

Kevin Hebner

Particularly, I don't know a lot about the elections we just had in Indonesia. I know something, I am Canadian.

Damien McIntyre

Oh, forgive me!

Kevin Hebner

But I will be voting November. This will be the first time I voted in a presidential election. Policy implications. The betting sites right now are saying there's a big gap between Trump and Biden. So there's a well over 50% chance that Trump will win, and that gap is getting bigger. There's still eight and a half months to go. So a lot can change and a lot always changes between now and then. But one thing that's different between now in 2016, Trump is much better organised. He already has his team together and he's putting up very detailed explanations of his policies on his website, which is donaldjtrump.com. And when you go through these, a number stand out, for example, one tariffs, he loves tariffs. He doesn't realise their taxes. He thinks that the country exporting, the US pays them. That's not true, US consumers pay them, but this is the way he thinks about it.

So 10% tariff on all imports, that's an average three times higher than today's level. So that's the starting point, tax cuts. So the 2017 tax cuts he put in place, going to make those permanent, that's fiscal stimulus, goodbye fiscal conservatism. Energy, we have this pivot from green to brown energy. US is already the number one oil producer, but this gets turbocharged. Industrial policy, we've seen lots of industrial policy under Biden. We see more under Trump regarding semiconductors, energy, autos, manufacturing. Regulations, Trump hates a swamp, he hates the bureaucracy. So there'll be lots of deregulation going through. Chairman of the Fed, Powell, Trump's been very clear that he would not reappoint them. He wants someone in place who's going to be dovish and is going to be more compliant to Trump's wills. In terms of geopolitics, Trump hates anything that smells of multilateralism, he doesn't think he needs to negotiate with any country regarding trade, climate, Taiwan, Iran, Ukraine, NATO, any of those things. So it's very much a unilateral approach.

And then regarding China, he's clear he wants to revoke China's most favoured nation status. That means they get the best tariff treatment out there. It'd certainly be hawkish on China, but he's also made it very clear he doesn't think the US should defend Taiwan, because Taiwan, he thinks stole America's semiconductor industry. So in the short-term you've got tax cuts, deregulation, and some other things. So they create a short-term boost to equity markets similar to what we had in 2017. But you think sort of more medium-term, he's adding fuel to the fire. We're already having economy that's working at capacity. All this pro-growth stuff, it's all inflationary and it means lower medium-term growth, higher inflation, higher interest rates. But I think at least now it seems the market's mainly focused on the short-term, likely impetus to equity markets.

Damien McIntyre

Now of course, the United States economy has been remarkably resilient in recent years, and it's almost safe to say that a soft landing is the most likely outcome through 2024. There's lots of drivers to the US economy, but one of the things that isn't talked about enough, I believe, is the extent and quantum of fiscal stimulus. What is it, 7% of GDPs or something of that magnitude. So if Biden is re-elected, presumably he will maintain that stimulus or close to. Do you think it'll be a different world under Trump? And what do you think that might do to the soft landing thesis?

Kevin Hebner

You're right, all standard economic indicators said, say a year ago or two years ago that we are heading to recession. So any well-trained economist would say 80% chance of recession and you'd have lots of ammo to back that view up. The view is totally wrong, and that's been the history over the last four years, right? If you apply your standard tools, they've been time and tested these tools, they've been wrong consistently for four years. So we really do have to be careful about beating our chest with our forecast over the next year or two. But I agree with you, fiscal stimulus mattered a lot. Trump is certainly promising a lot of fiscal stimulus. He'll have to work with Congress to do that. But the evidence seems to be that he's pretty good at browbeating Congress into giving him what he wants in many areas. And I think tax cuts would be one of those. I think for Biden presidency, if he had say Republican House instead of a borderline 50/50 Senate, I think it'd be much more difficult for him to have the normal fiscal stimulus.

But the one place where there is bipartisan support is industrial policy. So there's been 280 billion for semiconductors, different other areas, which I think we could have industrial policy backed up by pretty big sums of money.

Damien McIntyre

Interesting. Well, Kevin, in the interest of time, we've hit our 30-minute window. So unfortunately, I have to conclude our conversation, which I've really enjoyed. So thank you very much a, for coming to Australia this week. I sincerely hope this week is a success for you and for Epoch, and it'll be interesting to see how 2024 plays out.

Kevin Hebner

Yes. Yeah. Thank very much for your time today, Damien. It's been fun.

Damien McIntyre

Thank you very much.