Episode 8: The US economy and market outlook

In this podcast Chris Ogilvie of Investblue and Paul Eitelman of Russell Investments will be discussing:

- What are investors asking their adviser about?
- What is the source of inflation – supply driven or labour market – which will prove significant in the long run?
- How quickly will the Fed raise rates and what are they watching most closely?
- How are investors reacting to rising interest rates?
- How might market respond in 2022 to the current economic conditions?
- What is the role of real assets in the portfolio?
- What role do real asset play for Australian investors?
- What are the implications of the Ukrainian conflict for investment markets?
- Has the spike in energy prices accelerated the potential to include alternative energy sources in portfolios?

Moderated by David McDonald, CFA - IMAP Investment Specialist

IMAP Disclaimer (00:02):

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About Russell Investments (00:18):

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David McDonald - IMAP (00:40):

Welcome to this podcast in the IMAP Independent Thought series. Today, I'm joined by Paul Eitelman from Russell Investments and Chris Ogilvie from Investblue. We're going to be talking about the outlook for the US economy and US markets, and certainly quite a few interesting topics to go through today. Perhaps Chris, can I start with you and just ask sort of what sort of things clients are asking about at the moment? Maybe not necessarily just with the US focus, what sort of topics are front and center of their minds?

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Chris Ogilvie - Investblue (01:18):

I think that the major thing is obviously the conflict in the Ukraine at the moment. And I think we've been in an environment without any major conflict involving, you know, serious world powers for some time. So it's both concerning, you know, from a humanitarian point of view, but also for investors with markets reacting in traditional volatile way to conflict. So that's a particular issue. And I think the other thing that people are conscious of too, is the, you know, the rise of inflation and the talk of interest rates rising, you know, certainly more quickly than they had been proposed only just a matter of months ago. So they're probably the two big things people have got top of mind at the moment with markets,

David McDonald - IMAP (01:59):

Right? Yeah. Thank you. And Paul, I know, you know, inflation and interest rates, big topic in, in the us. And you know, perhaps we can talk a little bit about the Ukraine later, but I suppose the upfront question is, do you see inflation as being a sort of short term thing, people have talked about supply chain issues and the like, or do you think it's something that's in and maybe going to be around for longer?

Paul Eitelman - Russell Investments (02:24):

I guess the complicated answer is it's a little bit of both. For the last 12 months, I'd say by and large has mostly been a, a transitory phenomenon in the United States where the lions share of the inflation overshoot has been very concentrated and driven by durable goods items. So with a lot of Americans stuck at home, consumer demand has been very concentrated on items like buying new TVs, buying furniture, buying automobiles so incredible demand in a small area of the economy. And those same areas have also been worried by supply chain bottlenecks. So if you decompose core CPI inflation in the United States, it's running it around 6% right now, which is obviously way too high, right? Half of that is being driven by durable goods alone. And that's a very unusual phenomenon and is likely to moderate over time as supply chains eventually heal.

Paul Eitelman - Russell Investments (03:26):

I guess we've gotten more concerned at the margin in just the last month or two, because we're starting to see some more sticky inflation emerge now as well. And, and in particular, that's coming from the strength of the us labor market, which is arguably about as hot as it's been in the post world war two period. And we're now seeing US wage inflation, running it around 6%. And, and that's incredibly high from a historical perspective and is really challenging. The Fed's sort of conviction around their 2% price, stability target. And so that's creating some more challenges over the medium term. So we ultimately think inflation rate should moderate as the durable goods issue resolves itself in the year ahead. But the wage piece is becoming more concerning. And I think getting the Federal Reserve's attention right now,

David McDonald - IMAP (04:16):

Right? So certainly not hanging around the 6%, but do you still see it as above the Feds 2% for the next little while?

Paul Eitelman – Russell Investments (04:25):

That's right. So around the end of this year, we're thinking core PC inflation, which is the measure that they focus the most on will probably be around two and a quarter percent. And so that's a significant moderation from where we are now, but still a little bit too high for them over the medium term.

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David McDonald - IMAP (04:40):

Right. Right. I guess that does take us to the, to the interest rate outlook. I mean, Ukraine aside, perhaps we can talk a lot about that in the moment that you know, people have been getting fairly aggressive on what they think the fed might do this year and what's the Russell investment view of the Fed.

Paul Eitelman - Russell Investments (05:01):

I do think they're going to be hiking interest rates here in pretty short order. They, at the end of the day have two main objectives, which is to keep the us economy at full employment and to achieve price stability of 2% inflation. And they're probably at, or beyond full employment and definitely beyond where they'd like to be on inflation right now. And so there's a really strong impetus from them to hike interest rates. And our view is they will embark on liftoff at their meeting in a couple of weeks in March 2022. I don't think that's a very heroic forecast anymore because Chair Powell was talking in front of Congress just yesterday. And he said exactly that, that he's going to put forth a proposal to hike rates by 25 basis points. So I think that is very squarely in the price at this point.

Paul Eitelman - Russell Investments (05:51):

The bigger question for investors is probably how much the Fed delivers cumulatively over the entirety of 2022. And in that context, our baseline is that they'll ultimately deliver around four rate hikes this year. The market is priced for six. So we're a little bit more conservative than the market. And it's really based on an expectation that over time, the inflation pressure should moderate a little bit, and that will allow the fed to slow down as we get into the second half of 2022. So definitely hikes here and now probably March, May and then June. And as we get into late 2022 the Fed potentially slowing down the pace a little bit.

David McDonald - IMAP (06:35):

Right, and I know Mr. Powell made comments and we've seen here in Australia, our own Reserve Bank making similar comments that given what's going on in Ukraine, they might sort of take a little bit longer or think a bit more carefully about what they're going to do. Do you think at the moment that that's likely to have an impact on the outlook for Fed hikes,

Paul Eitelman - Russell Investments (06:59):

It certainly creates more uncertainty for them. And the way Powell characterised it in front of Congress is he still wants to hike rates, but they're going to proceed cautiously and not try to inject more uncertainty into what is a very uncertain picture. And so I think there's a couple of things the Fed is going to be focused on here. Probably most notably is just how much commodity prices and energy prices in particular have spiked globally. That creates a little bit of inflation in the short term, but it also creates some question marks about how the US consumer might respond to higher energy prices, which are basically a form of attacks. And so they're going to be looking really closely at probably the consumer data here over the next three to six months for any signs of damage. And if they were to see it, I think that would bias them to want to slow down a little bit. So I think on, on balance, it's probably a little bit dovish, but the intent is to, to carry forward and just be really careful around the data as it comes through from those risk factors.

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David McDonald - IMAP (08:02):

Right. Thank you. So, Chris, I guess high interest rates and high inflation are something that a lot of clients maybe even never seen, or certainly older clients haven't seen for several decades is that sort of making them more as people just know how markets are going to react?

Chris Ogilvie - Investblue (08:25):

I think so, David I think there's a bit of a disconnect between, you know, and from a client's perspective as to the interest rates they experience on their bank deposits or the loans that they pay versus the bond yield rising. So your typical client is not understanding necessarily of that disconnect, but you know, those that have been around before, you know, and had mortgages in the seventies or the eighties are fully aware of the higher interest rates and you know, what the seventies delivered with obviously inflation. So you are right as there's a whole host of people that have only been used to rates effectively decreasing over time causing that sort of wealth effect that they've enjoyed. And inflation is a new beast that many people are trying to understand what impacts it's going to have in the real world.

David McDonald - IMAP (09:13):

Now Paul, you mentioned the market pricing in pipes up to six rate hikes, which is more aggressive, does that make you a bit more positive on bonds, for instance, do you think they've priced in too much?

Paul Eitelman - Russell Investments (09:31):

We're not particularly bearish on bonds. I think that's a little bit more of a consensus for you to think interest rates are likely to rise sharply given the, the high inflation environment, but if the Fed is preceding, but proceeding cautiously and inflation rates do moderate the US tenure bonds today at around call it 1.8 or 1.9% is in the vicinity of where we estimate its fair value to be against a backdrop of pretty weak trend economic performance in the United States, aging demographics cetera. So our preferred stance on duration exposure or government bonds in the United States is to be pretty close to our long term strategic targets to be around neutral. I think bonds are not a particularly attractive return driver in multi-asset portfolios right now. Given real interest rates are negative, but they do still have an important role to play in terms of diversification, if something goes wrong and we were to have an economic recession, if it were to be by geopolitics or something else unexpected to happen. And I think that that role in portfolios is still very important today. So yes, we're sitting here pretty close to home in terms of desired duration exposure around government bonds.

David McDonald - IMAP (10:56):

Okay. And you mentioned there Paul that there's some sort of weaker macro drivers in the US demographics and so on, but do you still see the sort of very strong growth low in employment we're seeing at the moment continuing for a while? Do you have a positive outlook?

Paul Eitelman - Russell Investments (11:16):

Yeah, I think 2022 should still be a very good year for the US economy. And a lot of that's driven by the strength of household and corporate balance sheets here in the states. If you're looking at the consumer, they're sitting on almost double digit household income growth right now, driven by the strong wage gains that we talked about, but also very excellent job growth. So that's a really nice, important, positive pillar for the consumer, which drives about 70% of eco-economic activity in the us. And the corporate sector's in good shape too. And this is a global phenomenon, but in the US last year, we had almost 50% earnings growth for S&P 500 index companies.

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And with that excellent earnings companies are now flush with cash and have a lot of ability to invest. And I think frankly, a need to invest given the supply chain challenges that we're seeing globally. So with a healthy consumer and a healthy corporate sector, our expectation is that we'll have around 3.5% real GDP growth this year in the us, which is well in excess of that weaker long term trend due to demographic issues. So ultimately, yes, we are thinking this will be a quite good year for the US economy in 2022.

David McDonald - IMAP (12:37):

So the geopolitics aside are you positive on equities? Do you see that it's a time perhaps after the falls we've seen recently to add risk?

Paul Eitelman - Russell Investments (12:52):

I think the equity outlook is reasonably positive over the medium term. Valuations are quite rich, but we're in this stage of the business cycle now with pretty healthy economic and earnings growth, that equity should be able to deliver something around what they're delivering in terms of earnings. So if we have an expectation going forward for three and a half percent real GDP growth, and maybe a bit better than that high single digit earnings growth US equity markets probably can deliver a mid to high single digit return outcome going forward. I think at the margin, we're probably getting more interested in the current environment of geopolitical tension because we're starting to see more pessimism come through in market psychology and investor psychology. And whenever that happens it tends to be a really good sign of forward meaningfully positive equity market performance. So I think that view around the cycle looking pretty good coupled with some pessimism in the market are the sort of two positive ticks that, that have us leaning positive in terms of equity market outlook here.

David McDonald - IMAP (14:07):

Okay. Thanks and Chris do you see that sort of pessimism or concern growing among your clients around the equity market outlook?

Chris Ogilvie - Investblue (14:19):

Probably not yet. David, I think there's, you know, people have weathered the storm pretty well during the, the volatility in the COVID period, especially when COVID first came out, and they've seen the benefit of, you know, persevering and staying true to the course and, and the rebounds sort of occurred. So I think there's probably a little bit more unease at the moment because of the nature of what's driving markets. I think obviously inflation and interest rates are beyond people's control, but certainly the geopolitical risks are quite worrying for people having said all that. Is there certainly not seeing any signs of people panicking or behaving the wrong way at this stage.

David McDonald - IMAP (15:02):

Okay. Paul, we we've talked about earlier about how, and a lot of people haven't seen inflation at these sort of levels, or hasn't been around for several decades even. And how do you see equity markets performing? If we have extended period of higher inflation, is it a positive or a negative?

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Paul Eitelman - Russell Investments (15:25):

It ultimately depends on what's happening with growth at the same time. So if the inflation's being driven by really strong demand as has been the case for the better part of the last 18 months in those kinds of environments, equities can offer a pretty reasonable inflation hedge for investors when companies have pricing power and, and earnings are coming through where that starts to break down is if we were to transition back into an environment closer to the 1970s, one of stagflation where you have high inflation and weak growth at the same time in that kind of scenario equities are likely to sell off in addition to a whole host of other asset classes net, as I discussed, an environment of moderate moderating inflation and reasonable economic growth, we think that's a pretty favorable environment for equity market performance.

David McDonald - IMAP (16:21):

Right and looking at other asset classes … some people suggest that there's inflation protection in real assets in property infrastructure, things like that, is that something you would favor?

Paul Eitelman - Russell Investments (16:37):

Yes. We do like investments in real assets here over the medium term, and they've actually had some pretty good demonstrated protection to inflation concerns year to date as well. If you think about global equities so far in 2022, they're down ballpark 8% Res are outperforming equities by about a hundred basis points. And global listed infrastructure is closer to flat in the year to date and so much more resilient than global equities. And we think that protection and hedge profile of real assets is an important contextualize going forward. And a lot of it's just driven by the flavor of those asset classes. Many infrastructure assets have pricing that is explicitly linked to inflation. And infrastructure sub sectors like energy transportation have really nice inflation characteristics as well. So when we kind of look at the space, yes, it's a good inflation hedge. And what we're observing in terms of the valuations of RES and infrastructure, we're seeing a little bit of a discount relative to global equities on things like a price to earnings basis. So that valuation coupled with the inflation characteristics does make them attractive asset class over the medium term.

David McDonald - IMAP (18:08):

Yes I mean, a lot of our toll roads here in Australia have direct CPI linked pricing, which is great for the toll road owners, but maybe not so good for those of us that drive on them at the moment. But Chris, do you know if clients have much exposure to these sort of assets we've talked about like infrastructure and you know, commercial property and the like.

Chris Ogilvie - Investblue (18:36):

Yeah. Increasingly, and I think people are attracted by the things they understand that they can touch and feel and drive past and look at. And in some cases, those unlisted assets give them that comfort that they've got a portion of their portfolio potentially that's not exhibiting the volatility of listed markets. So I think it is something that clients have got a strong appetite for, and certainly does form an important part of a portfolio.

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David McDonald - IMAP (19:05):

All right. We've touched briefly on geopolitics and what's going on in Ukraine and so on. And I guess it's still a very much who knows where it's going or, or how bad things are going to get, but Paul can we just touch on what you think implications could be for global markets and even for economies, if things get worse or the conflict is extended?

Paul Eitelman - Russell Investments (19:34):

Yeah, absolutely. I mean, it's a horrible situation in Ukraine for markets. The immediate reaction as we've talked about is one where we're all having to think about new uncertainties here that we haven't considered in a very long time, and financial markets don't like uncertainty. So I think it has some negative pressure in global financial markets in terms of implications. The obvious ones are that Russia is likely to be in very bad shape here economically in the year ahead. We would expect their economy to get clobbered by the sanctions from the West, the shut out of their banking system from the West and a number of global multinational businesses basically turning off capital flows to the region. In a lot of ways, it feels like one of these classic sudden stop episodes that a lot of emerging markets have had to deal with in decades past.

Paul Eitelman - Russell Investments (20:30):

So I think for Russia, specifically very negative for the global economy, exposures to Russia have decreased meaningfully since 2014 around the Crimea annexation and sanctions from that time. So the global spillovers are probably much more modest. The two risks we're thinking about as scenarios are number one, if the war were to escalate to countries, that would be quite bad, but I think is a low expectation probability from most investors in geopolitical experts that we speak to the other more pressing. One is what the spike and commodity prices and energy prices means for developed markets. And we're seeing now crude oil move well above a hundred dollars a barrel. And I think that creates open questions. What kind of damage there might be for consumers in places like the United States and Europe, and on that issue, we're probably getting a little bit closer to the danger zone. My expectation would be the us should be quite resilient here given the increasing energy independence. The American economy has developed over the years due to the she revolution and other issues, but in Europe they're much more dependent, and much more dependent, particularly on Russian oil and gas. And so I think we're probably already getting to the point where investors need to think about a percentage point or, or two of downgrades to their economic as still reasonably headwinds, particularly outside of consequences from this.

David McDonald - IMAP (22:22):

And have you ever been able to have a look at how markets have performed in the past when we've had these sort of geopolitical happenings, if it's not sort of any major extension?

Paul Eitelman - Russell Investments (22:37):

Yeah, so we looked at major geopolitical scares going all the way back to the 1940s. And what you tend to find is an initial, fairly large selloff in financial markets, as investors grapple with the uncertainty. But over time and this can happen pretty quickly, you tend to get a pretty quick and full recovery in global equity markets on average in the span of just a month or two. So I think that's the sort of historical norm that there's a fear factor and you get over it in global fundamentals are ultimately what prevails. And so I think that casts a message of one where you probably want to stay invested and stick to your plan during times of stress and fear in markets and at the margin, as we were talking about before, if we

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were to see wide scale panic in the market, we may even want to consider actually going overweight equities. We're not quite there yet. We're seeing pessimism, not panic in terms of market psychology. But increasingly getting interested if the volatility were to persist and potentially even in the weeks ahead.

David McDonald - IMAP ([23:44]):

Right. Chris, does that require a lot of hand holding of clients or you think that clients are sort of aware of this, and that it's often just a short term drop and staying puts probably the best strategy.

Chris Ogilvie - Investblue ([24:01]):

Yeah. David, I think in the work you do with your clients over a long period of time, there is an element of education mentoring sort of coaching along the way, and people hopefully have got the message having said that these times can be unnerving. And I think people trying to time markets is brought with danger. All the statistics will tell you that probably gives you two chances to get it wrong when to get out and when to get back in. And as we often say to people, the safest place to be on a rollercoaster is buckled up and enjoying the ride. And you get through the other end safely. It's not the time to unbuckle when you're on the rollercoaster.

David McDonald - IMAP ([24:41]):

One, I think one, maybe one final topic that occurs to me and we've got our portfolio management conferences coming up soon. And one topic that comes up in, in some of those is climate change. And I just think, you know, with the spikes we've seen in energy prices, Paul, and you know, the oil over a hundred dollars a barrel and so on. Do you think it's perhaps another driver for the alternative energy sector that we might see things develop quicker there?

Paul Eitelman - Russell Investments ([25:11]):

I think it creates an impetus to try to find energy supply anywhere you can. And particularly in Europe, given the strong ESG focus in the region we could be looking at meaningful investments to build out their domestic energy production profile, including alternatives and maybe a reconsideration of nuclear. Those kinds of investments could take many years to play out. So it doesn't solve the problem overnight, but I think there'll be sort of increasing interest in that back here in the United States. And this was included in President Biden, state of the union presidential address. I think there's a big interest to try to ameliorate the price at the pump and the challenges consumers are facing from higher energy prices. And that could include a range of things, but potentially even bringing back more US production, which has been quite constrained, frankly in terms of new investments for the last year or so. And that's, that's a little bit of a dirtier flavor of energy investment, but given the hyper focus on, on politics right now, I think it's a reasonable avenue that the us policy administration could likely consider here.

David McDonald - IMAP ([26:35]):

Thank you there's some very interesting topics in there. So I would like to thank Paul Eitelman of Russell Investments and Chris Ogilvie of Investblue. Thank you for your time today. And a reminder that our next podcast in the series coming up soon is looking at duration and global equities. And also a reminder, if you look on the IMAP website, we have our portfolio management conferences coming up soon in both Sydney and Melbourne. Thank you very much.

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