Macro Overview: Navigating Through Complex Times

by Andrew Clifford, Co-Chief Investment Officer

In late March, CEO and co-CIO Andrew Clifford sat down with Investment Specialist Julian McCormack to discuss the quarter's dramatic world events and what they mean for inflation, interest rates and markets. An edited transcript of the conversation is below.*

JM: Andrew, after starting the new year on a strong note, financials, industrials and materials, essentially cyclical stocks, reset lower in February on fears around the Russia-Ukraine conflict, what are your thoughts on a 3-5-year view?

AC: I think it's worth returning to where we were before the invasion of Ukraine and COVID really took hold in China. We were in a situation where we were clearly coming out of the pandemic, countries were reopening, there had been a huge amount of fiscal stimulus across the world and economies were looking in great shape. We also had an extraordinary rise in inflation to levels we haven't seen in 40 years, and with that, there was the realisation that interest rates were going to rise, and by a quite a lot. That environment was going to be very positive for financials, industrials, materials, travel stocks, and the like. Indeed, towards the end of last year and the first few weeks of the new year, they were doing very well. On the flipside, it was also an environment that was going to be very challenging for the stocks that had driven markets for the last three years, particularly the last two, the growth stocks or 'quality compounders' as they are often referred to. Indeed, some of the big favourite names like Facebook or Meta Platforms as it's now called, Netflix and other excitable growth names experienced some significant setbacks. These are the types of stocks that trade on 20, 30, 50 times sales and have serious valuation implications in a higher interest rate environment. I would add that when it comes to bull markets, there are two things that happen: there's a great story; and the story gets better in people's minds as the prices reinforce it. The story is correct, but when rates suddenly start rising and stock prices stumble, people start looking more closely. A stock such as Facebook, for example, has gone from being an unsurpassed media giant for digital advertising, to a company really struggling in terms of competition and changes in its environment. Netflix, likewise, has been through similar challenges. So, as people start paying more attention to these stocks, we start to get a very different stock market environment.

JM: Interestingly, people have returned to those kinds of exposures, the quality compounders, in recent weeks, driving astounding performance in stocks like Tesla, Microsoft and Apple. What do you make of that?

AC: To me, it seems to be a reflex action for investors that's been driven into them over recent years. We have talked a lot over the past five years about how people were 'forced' into equities. They didn't really want to leave the safety of their bank deposits but had no other option in order to get returns. They wanted to invest in something they felt comfortable with, that was 'safe'. And that's certainly what the quality compounders and the Microsofts of the world appear to offer. We have gone from a period where investors were probably gaining confidence, there was an economic recovery underway and yes, interest rates were going to rise, but it wasn't the end of the world, to now facing a war on the Continent. There are also questions about China's role in the Russia-Ukraine conflict and the implications of that, as well as concerns about the strength of the Chinese economy,

*The full interview is available in audio format on The Journal page of our website https://www.platinum.com.au/Insights-Tools/The-Journal which continues to struggle. The huge increase in uncertainty sees the "let's go back to safety" playbook come out yet again. While it doesn't surprise me, what I do find extraordinary this time, is that people actually want to return to these stocks, despite rates now rising. We always tend to focus on the US, but central banks across the world have been raising rates for a while. In the US, I follow the 2-year Treasury yield as an indicator of future rates and it's up around 150 basis points just this year (see Fig. 1). Investors wanting to go back to assets where the value won't be realised for many years out, so there's a discount effect,[1] is pretty bold in my view, especially when the US Federal Reserve (Fed) has reiterated they will be increasing rates. It's worth noting that following the invasion of Ukraine, European lead indicators, such as consumer confidence and business confidence, now look dismal and the economy is most likely going to have a very strong, short disruption at the least. China too is facing a difficult period because of COVID. In contrast, the US economy, for the moment, doesn't look to be skipping a beat, and in fact, taken in isolation, the worry there is that rates may go up much further than many expect.

JM: It's interesting in that context, maybe you could reflect on the process of going from extreme bullishness to bearishness, using past market cycles in terms of timing?

AC: It's always interesting to reflect on some of the timeframes involved. If you go back to 2008 for instance, and from recollection, it was around February when the Bear Stearns issue arose, there had been problems in the mortgage market leading up to that, but yet it wasn't until August that things really came to a head. In more ancient history, I was recently reviewing the end of the Japanese bull market in December 1989. Japanese government bond yields had risen sharply that year, from around 5% to 8%,[2] so it took a while for the market to crack, but then it certainly did happen. The lesson here is, it can just take time. I think it's worth talking about the other side of the equation too, the stocks that are out of favour, where valuations are back to crisis levels. While we don't know what the next three or six months will look like for companies such as BMW or Eastern European bank Erste Bank, two very high-quality businesses in our view, they are trading at levels last seen in the depths of the COVID sell-off or the 2009 sell-off in terms of their valuations and the strength of their underlying businesses.

1 Growth companies tend to rely on earnings in the more distant future. When valuing a company, future earnings are discounted back to a present value using a required rate of return, which is related to bond yields. As bond yields rise, the discounting process leads to a lower value in today's dollars, for the same level of future earnings.

2 Source: FactSet Research Systems.

Fig. 1: US 2-Year Treasury Yields

Source: Bloomberg as at 31 March 2022.

JM: I am reminded of the common refrain that as everything goes down all at once anyway, we might as well hold the current winners. Does it matter what you own?

AC: Well, if you look at history, there's one great exception to that, which was the end of the tech boom in 2000 and 2001. As tech stocks sold off, all of the out-of-favour companies back then, the 'old world' companies like spirits businesses and consumer staples that were trading on discounted valuations of around 11 or 12 times earnings, were actually rising. The sell-off in 2008/09 was indeed a case of everything going down at the same time. However, the better-valued stocks tend to not go down quite as much and recover much earlier.

Reflecting on last year, certainly there was some good buying to be done in a Microsoft or Facebook in March, however, there were much better buying opportunities in copper stocks, like Freeport-McMoRan or First Quantum Minerals, which were up 50% and 80% respectively over the year to the end of March 2022.[3] At the end of the day, you have to get through the cycle to see how it all unfolds, but when we're buying a stock like BMW at 60% of its book value and there's a shortage of cars that will take two or three years to resolve, I think that's great long-term investing in the very traditional sense and not punting stock prices.

3 Source: FactSet Research Systems.

JM: Changing tack slightly, the other great area of focus for investors is China. We've seen an extraordinary response in perhaps some of the more speculative areas of the Chinese market following comments from Chinese Vice-Premier Liu He. Do you have any comments on that?

AC: Firstly, I would like to make an overall comment here, because there are a lot of fears about China, particularly its relationship with Russia. Clearly, China wants to play a very independent role, rather than a more neutral role. We need to remember that the US sanctions against Huawei effectively destroyed one of the greatest private companies of the world, so China naturally has genuine reasons to be fearful of the West and their role here. However, China's success is a product of being part of the global system. Their wealth and livelihood are a function of being part of that system, so to my mind, the likelihood that they will endanger that, is very low. I think that the worst fears are extreme here.

Now, clearly, the reforms of last year have hurt their economy, which they are well aware of, and COVID is now another blow for them. They need to get the economy going again, which explains why Vice-Premier Liu He, in a speech in mid-March, vowed to support economic growth and the capital markets, with notable mentions of the real estate and technology sectors, which have been impacted by regulatory crackdowns. There were also stimulatory measures announced, including tax cuts worth a percent or two of GDP.

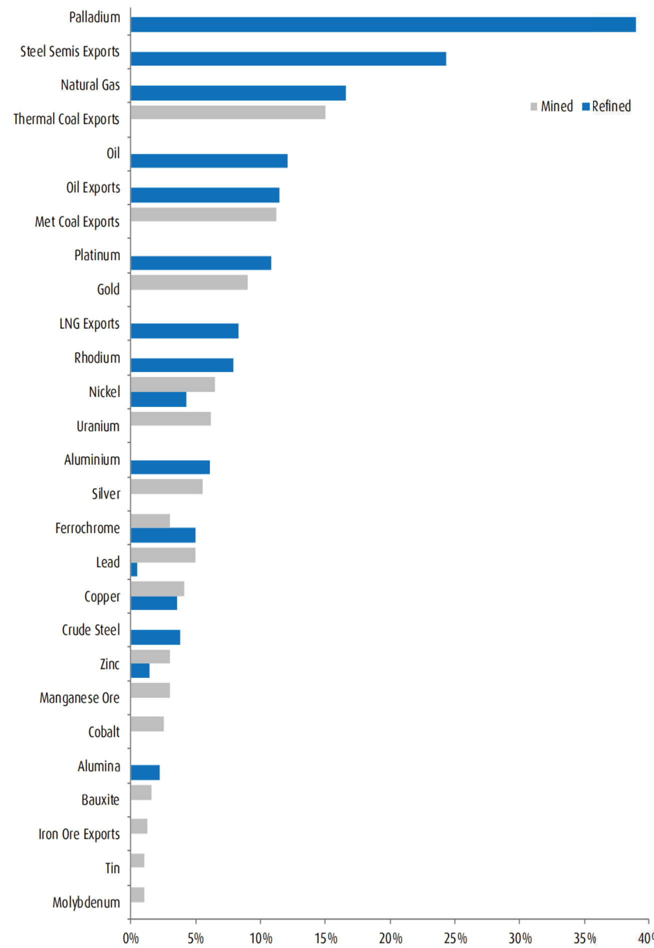
There are also a lot of concerns around Chinese American depository receipts (ADRs), with the US regulator, the Securities and Exchange Commission, looking at potentially delisting some Chinese companies from US stock exchanges. However, that is a sideshow really, because companies are just relisting in Hong Kong. Interestingly though, China has changed their position and is taking a highly conciliatory stance, trying to appease the US.

Back to your question regarding the market reaction, Chinese stocks were very cheap to start with, they were in a big bear market already, and then we had that extraordinary sell-off that only lasted for a couple of days. A bounce on the back of the positive statements was to be expected, but I think there is still some pretty interesting value in that market today.

JM: Apart from the human suffering from events in Ukraine, there are other real-world economic implications globally, can you touch on some of those?

AC: One major repercussion from the Russia-Ukraine conflict is obviously energy prices - not just oil, but also gas and thermal coal. These markets were already incredibly tight and while it's impossible to predict how the war will unfold from here, short of a regime change, Russia will most likely remain a pariah state. On that basis, it's reasonable to expect elevated energy prices to continue. Another area that has been impacted is food prices and associated input costs, like fertilisers. Ukraine and Russia are huge suppliers of grains, notably wheat, but also fertilisers (potash). Our discussions with people in those markets indicate this is a very significant disruption, particularly in fertilisers, which is not going to be easily resolved. There are obviously humanitarian consequences of higher food prices in very poor countries. In terms of market implications, energy and food are the biggest components of household budgets, particularly for low-income earners in the West. This has a real impact on not just the average consumer but also businesses selling to those consumers. There are lots of swings and roundabouts, you can't ever assume that just because you are selling to lower-income households that you lose out, you might be able to increase prices, consumers may still buy your product, but then save elsewhere. However, there are going to be implications and it creates a very complex environment for investors.

Fig. 2: Percentage of Global Supply Sourced from Russia



Source: USGS, BMO Capital Markets.

JM: Obviously, it's different this time, but how would you compare and contrast that setup to how you were seeing the markets in 1999 and 2000?

AC: There's much greater complexity in the economic environment this time. Like the current situation, certainly in 1999/2000 we had interest rates going up and there were extraordinary valuations in some sectors, while a part of the market that had been left behind looked very attractive. But let's remember that in 2000, it was all about Y2K, which caused people to misread the situation. There was considerable demand for IT, which turned out to be driven by this artificial deadline for everyone to revamp their systems. This time, to some extent, I think we have the same possibility, with huge demand for physical goods. We have the potential now that everyone is misreading demand for say, homewares or other goods that have been in great demand. In the IT area, the amount of money available for start-ups is extraordinary. You can see on the front page of the financial papers every day about someone raising another US$100 million on a billion-dollar valuation - and they've barely even got started and that US$100 million goes into a lot of IT services. For some of those much-loved software companies, sales aren't actually on trend, they're way above trend. In our view, it's very likely that we're going to have ongoing disappointments over the next year or so, particularly in those companies that are trading at incredibly stretched valuations.

With interest rates likely to move higher, I think the long duration stocks, the quality compounders, are going to be, at best, very low-returning investments. We feel there's just far better value in a whole range of other stocks that we've already touched on - the industrials, materials and banks and so on.

MSCI Regional Index Net Returns to 31.3.2022 (USD)

REGION	QUARTER	1 YEAR
All Country World	**-5.4%**	**7.3%**
Developed Markets	**-5.2%**	**10.1%**
Emerging Markets	**-7.0%**	**-11.4%**
United States	**-5.3%**	**13.6%**
Europe	**-9.6%**	**1.1%**
Germany	-12.9%	-12.0%
France	-8.7%	4.5%
United Kingdom	1.8%	13.6%
Italy	-10.0%	-2.7%
Spain	-4.1%	-3.7%
Japan	**-6.6%**	**-6.5%**
Asia ex-Japan	**-8.0%**	**-14.6%**
China	-14.2%	-32.5%
Hong Kong	-1.8%	-12.0%
Korea	-9.6%	-18.5%
India	-1.9%	17.9%
Australia	7.3%	13.5%
Brazil	35.9%	24.7%

Source: FactSet Research Systems.
Total returns over time period, with net official dividends in USD.
Historical performance is not a reliable indicator of future performance.

MSCI All Country World Sector Index Net Returns to 31.3.2022 (USD)

SECTOR	QUARTER	1 YEAR
Energy	21.2%	40.0%
Materials	2.8%	10.9%
Utilities	1.2%	10.7%
Financials	-0.4%	11.1%
Health Care	-3.8%	12.6%
Consumer Staples	-4.0%	7.5%
Real Estate	-5.5%	9.5%
Industrials	-6.0%	1.5%
Information Technology	-10.3%	12.3%
Communication Services	-10.6%	-7.4%
Consumer Discretionary	-11.3%	-5.5%

Source: FactSet Research Systems.
Total returns over time period, with net official dividends in USD.
Historical performance is not a reliable indicator of future performance.