

Macro Overview: Forget Picking the Bottom, Focus on Value

by Andrew Clifford, Co-Chief Investment Officer

In late September, CEO and Co-CIO Andrew Clifford sat down with Investment Specialist Julian McCormack to share his thoughts on interest rates, inflation, China, and Europe - and what they all mean for markets and Platinum's portfolios. An edited transcript of the conversation is below.*

JM: Andrew, there is a lot going on in the markets. Let's start with interest rates, how far will they go?

AC: This is everyone's question at the moment, and understandably so. The typical approach to answering this is to examine the underlying components of inflation and where they're heading. There is a lot of evidence indicating that inflation is starting to peak, although the one thing that is holding up is the employment market, which is still surprisingly robust. But at some point, inflation will roll over. I think the bigger issue here is how much interest rates have moved already. We've just been through one of the most extraordinary increases in interest rates. Coming off near-zero rates, yields on two-year US Treasuries are now around 4% and 10-year yields aren't far behind.¹ These are levels we haven't seen since 2008. When that degree of change in funding costs occurs in the economy, you have to expect some fall-out from that. One really interesting number is the cost of a mortgage in the US. Average monthly payments on a new mortgage for a median-priced house at current prices are up around 60% from a year ago, they have almost doubled from the pre-COVID period, and are up threefold from the lows of 2013/2014 (see Fig. 1). US households predominantly have fixed-rate 30-year mortgages, so they obviously aren't actually paying the higher payments, but it provides a real sense of just how much funding costs have changed in that economy, and it's not surprising to see activity in the US housing market in free fall. We need to turn our minds to the damage in the economy. I think what we have ahead of us is a very difficult period for company earnings across the board.

Fig. 1: US Monthly Mortgage Payments



Source: Piper Sandler.

JM: That comment about fixed mortgages is interesting. It's not costless. So, how do you move house when you can't take on a new mortgage?

AC: It's one of the interesting side effects of the US fixed mortgage market. For many people, they just simply can't afford to move. They have a good mortgage deal where they're living, and that is impacting labour flexibility at a time when the economy needs it the most. It works against one of the US' otherwise key strengths, in terms of the way people move around for jobs.

¹ All market data in this Macro Overview are sourced from FactSet Research Systems, unless otherwise stated.

*The full interview is available in audio format on The Journal page of our website <https://www.platinum.com.au/Insights-Tools/The-Journal>

JM: If you're the US Federal Reserve, do you pause, keep raising, or cut?

AC: Well, I'm glad I'm not the Fed. It's not really a question for us as investors of what they *should do*, it's simply just a question of what they *will do*. Two or three years ago, when central banks were saying rates would be zero until 2024, I said, "Well, you shouldn't believe that". They tell us that because they need to build expectations in. They want you to believe it, so whether you're a consumer or a business, you will act as if rates are going to stay very low. Similarly, today they have to say rates are going up and build that same expectation. While they might slow the frequency and size of the rate increases, which will, of course, come to an end at some point, I think we're a long way away from seeing dramatic cuts in rates. There is a very real risk that if the Fed cuts rates too quickly, with those strong employment numbers and inflation still well ahead of interest rates, that they will reignite those inflationary forces.

JM: What could come out of left field in terms of monetary policy or its reformulation that could really change things?

AC: What I'd say, which is not answering your question directly, is that we've acted for a long time as if there are no limitations on the actions of governments. But the real economy, which is labour, people going to work, and the capital they use, is the real limitation on the economy. All governments are doing is redistributing funds and resources around the economy, and there are limitations on what they can do. We had a great example recently in the UK with the new Prime Minister, Liz Truss, and the new Chancellor of the Exchequer, Kwasi Kwarteng, thinking that they just needed to spend money to get things back up and running in what has been a very weak environment. The market didn't respond well to their proposed £45 billion mini-budget, comprising unfunded tax cuts and temporary measures to help with energy bills.² The market said there is no way they are doing that, because simply, it requires the rest of the economy and the globe to fund that decision. The UK government subsequently backtracked on cuts to the top tax rate. Inflation is telling us that we've come up against the limitations of how governments can spend.

JM: Let's go to the opposite extreme. How would you characterise China's situation and outlook given its last 40 years of economic history?

AC: There are a few questions we need to address around China, but I'll start with the simple economic one; the country is in, let's call it, a recession. Whatever the numbers

say, this is the most serious downturn in growth since the economy opened up. At the centre of that downturn is a collapse in sales of new properties that is flowing through to construction and activity. This is a very important part of the Chinese economy and the collapse in volumes has come about as a result of policies designed to cap property prices. It's been a severe policy error that has destroyed households' confidence in the property market and property developers. The idea, though, that some great property bubble has popped is not really on the mark. They have not delivered nearly the amount of modern housing stock that the Chinese population needs. They have a problem. It's like a liquidity trap. Nobody wants to buy a property because they don't know if the developer is going to honour their commitment to develop the property. Confidence needs to be restored. There are announcements all the time of rescue funds being provided to the developers, not to get those developers back on their feet, but to ensure that these half-finished developments go ahead and are completed. I believe they're heading in the right direction on this front, and if they fix that problem, I think that will solve the economic slowdown there. Property sales may not get back to the huge, very high levels they were at, but they will most likely recover.

Of course, China has also had a resurgence in COVID, but we know that countries exposed to COVID get through it, one way or another. I'd be surprised if we weren't moving on shortly from that in China. We are also seeing lots of stimulatory actions. Monetary growth in China, for instance, is now accelerating and at the highest levels for quite a few years. In sum, we are very optimistic that China will come out of this recession, just as we would be for any normal functioning economy coming back from a downturn.

The other, obviously bigger issue with China that people are talking about is the political tensions with the West. Clearly, this concern will be with us for some time. My first response to this issue is always the same: our systems are so intertwined that for either side to ignore that in their interactions would have very significant implications economically, not just for China, but for the world. We can't predict the outcome; however, we would hope that good judgement prevails on both sides. When it comes to questions like an invasion of Taiwan, I think there is a lot of focus on the very unlikely possibility of that occurring rather than the things that might really happen, which could be quite damaging. I would add that the US security agencies that said Russia would invade Ukraine are saying right now that an invasion of Taiwan is highly unlikely and that there are no such preparations. It's more the middle ground where things can really hurt individual companies and portfolios; the very simple thing of sanctions, for example. Recently, the US imposed sanctions preventing NVIDIA from selling some

² <https://www.economist.com/leaders/2022/09/28/how-not-to-run-a-country>

of its high-end graphic processing units (GPUs) to Chinese customers, which is very damaging to its business. Clearly, you don't want to invest in companies that are close to the Chinese government. You also need to be aware that when investing in high-tech areas, if China is a big part of their sales base, that's a risk. So, as investors, we need to be aware of these risks and ensure that we're not overly exposed.

JM: Moving onto Europe, the outlook there is clearly somewhat gloomy. How are you framing the extremely weak consumer confidence, the industrial slowdown, and the vulnerability around energy, versus what is generally a pretty good jurisdiction?

AC: Obviously, the war has had huge humanitarian costs not just in Ukraine but across Africa in terms of food supplies. However, if we just focus on the economic and investment implications, one of the biggest impacts is on the cost of energy. Companies across the board have seen a substantial loss in their competitive positions due to the higher energy prices, and we've certainly seen closures in capacity of fertiliser and chemical plants and the like. On the other hand, this has also been reflected in a weaker euro. We've obviously seen very dramatic strength in the US dollar versus all currencies, not just the euro, including the Australian dollar and the yen. There's a slightly different story for each, but it's mainly a US dollar story, which benefits the rest of the world in terms of their competitive positions. For Europe, the fall in the euro, which has been quite substantial by historic standards, has helped to level out the impact of the higher energy costs on industrial companies and restore profitability. The unknown question is how long energy prices will stay at this level. I would expect that over a two-to-three-year period, the intense pain Europe is feeling now will ultimately dissipate as new sources of energy are secured. We have already seen Europe manage to secure a significant increase in LNG imports and the like.

JM: American corporations, which have enjoyed some measure of global dominance, have the reverse problem with respect to the currency impact on revenues. How are you thinking about these and the headwinds they face?

AC: It's interesting because there has been a very different market response in places like Europe and Japan to the weakening of their currencies. Normally, you would expect, particularly for Japanese companies, such as the classic exporters like Toyota, to perform relatively well in yen terms, maybe even maintain their US dollar price, given the huge benefit they get from that. You would expect similar outcomes in Europe too. But that actually hasn't happened this time. On the other hand, you would have expected quite a lot of concern about earnings for US companies, based just

on the strength of the US dollar. There's some talk about that, but not a lot. So, the market reaction has been very different to what we would have seen in earlier times.

I think this reaction partly reflects an aversion to business and geopolitical risk, but there's also recency bias at play here, where we remember what worked well before, so we go back to it. It's also worth noting that the US market was the most pumped up by monetary expansion, and while that's certainly faded, it's still benefiting from the tail-end of that, which is holding up US asset prices. It's been a really interesting market this year. In one way, there has been a stealth bear market for a number of years now for anything that's not in the 'growth' or 'defensive' camp. Their valuations have been continually marked down. When we entered this year, the world was looking like a pretty good place, so you would have expected economically exposed/cyclical companies to do well. However, we then had the extension of the recession in China due to a resurgence in COVID and Russia's invasion of Ukraine. As a result, companies that didn't meet those pure safety criteria have taken big hits, falling to crisis-level valuations - to levels that we saw at the bottom of 2009. Whereas the fade in glory of the great tech stocks is slow. We also saw this happen in 2001. It took a very long time for the likes of Oracle, Cisco, Dell, EMC, and Microsoft to reach their lows in both share prices and valuations, but they all ultimately fell to price-to-earnings multiples of 10, having been at 50, 60, or 70.

It will all depend on the earnings that companies deliver, because expectations are very high. The stock that has most severely disappointed investors to date is Meta Platforms (formerly Facebook), followed by Netflix in that group. Meanwhile, Google is an advertising business, and interest rates are rising a lot. I would be thinking very seriously about how earnings are going to unfold for that business in the next couple of years.

JM: People are quite obsessed with picking the bottom of markets. Going back to your initial point on interest rates, how much lower can US markets go? Or where are we in the market cycle?

AC: I think the best we can do is to look to history for a guide. We had an extraordinarily speculative bull market, particularly for companies with questionable business models with no earnings, or at the extreme, meme stocks like GameStop and so forth. This was driven by a huge torrent of money thrown at it by various policies that were put in place. Your natural inclination, given that the 'liquidity tap' has now been effectively turned off, is that this is going to be a pretty bad bear market. In the bear markets of 2000-2003 and 2007-2009, indices fell around 50%, and in some cases more in particular parts of the market. On that basis, I'm not sure

why people are thinking it's going to be a lot different this time. Having said that, though, there are opportunities out there now as many stocks are already down 50-60% or more. Some of those are stable businesses sitting on nice earnings multiples. We've highlighted many of these types of companies in the past, such as semiconductors and auto companies. There are some pretty interesting assets out there, but growth and tech stocks have yet to adjust. People have also been hiding in a whole range of other more boring things lately, such as consumer staples (food, household products), utilities, and the like, where their businesses actually aren't performing particularly well, but have managed to hold onto valuations that are well ahead of where they were two or three years ago. You need to keep an open mind. People ask us how we are going to try and pick the bottom. In a sense, our response is that we don't try to pick the bottom but just respond to the value in stocks, both in terms of what we want to buy and what we want to sell. We are buying stocks that we think have extraordinary valuations, and we'll wait for the recovery of their businesses to come. On the other side of that, where we see companies that we think are in problematic environments and have high valuations, we're shorting them.

JM: Am I right in asserting that, say three years out, it looks like a somewhat higher nominal growth world than the last cycle that allowed this amazing ebullience for things that could either grow or behave like a bond?

AC: I think we will most likely return to an environment which looks more like what it did a couple of decades ago, where we had reasonable valuations and you could make money if you owned companies that delivered on earnings against that. I think, as we've already spoken about, China has an opportunity to recover, and Europe, under a different set of circumstances of dealing with their energy crisis, will also recover. The US economy will need to experience a slowdown first. Economic systems are incredibly robust and it will come back down to the real assets in the economy and what drives growth. Too often, people just focus on the financial side, but in three-to-five years' time, we will come out of these downturns, and companies that are trading on single-digit PEs with earnings in line with expectations or better, should perform well and reward investors.

MSCI Regional Index Net Returns to 30.9.2022 (USD)

REGION	QUARTER	1 YEAR
All Country World	-6.8%	-20.7%
Developed Markets	-6.2%	-19.6%
Emerging Markets	-11.6%	-28.1%
United States	-4.8%	-17.6%
Europe	-10.2%	-27.0%
Germany	-12.6%	-37.1%
France	-8.9%	-24.0%
United Kingdom	-10.8%	-14.1%
Italy	-8.5%	-28.5%
Spain	-14.1%	-25.6%
Japan	-7.7%	-29.3%
Asia ex-Japan	-13.8%	-28.7%
China	-22.5%	-35.4%
Hong Kong	-17.0%	-22.3%
Korea	-16.4%	-40.7%
India	6.5%	-9.9%
Australia	-6.7%	-16.4%
Brazil	8.5%	4.3%

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 30.9.2022 (USD)

SECTOR	QUARTER	1 YEAR
Energy	-1.6%	16.2%
Consumer Discretionary	-2.8%	-27.1%
Financials	-5.9%	-18.7%
Industrials	-6.1%	-22.0%
Consumer Staples	-6.6%	-9.0%
Health Care	-7.0%	-11.5%
Information Technology	-7.3%	-26.6%
Materials	-7.6%	-18.5%
Utilities	-8.0%	-4.8%
Real Estate	-12.4%	-22.5%
Communication Services	-14.0%	-38.0%

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.

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