

Macro Overview: The 'Out of Favour' and Areas of Significant Change Offer Opportunity

by Andrew Clifford, Co-Chief Investment Officer

CEO and Co-CIO Andrew Clifford sat down with Head of Investment Specialists Dean McLelland in late March to share his thoughts on the stability of the global banking system, interest rates, the state of play in Europe and China's reopening - and what they all mean for the markets in 2023 and Platinum's portfolios. An edited transcript of the conversation is below.*

DM: Banks were the biggest news during the quarter and while many people have heard of Credit Suisse, Silicon Valley Bank in the US was probably not a household name until quite recently. How are you thinking about the stability of the financial system and the likely economic impacts?

AC: I'd like to start by revisiting what we've been saying about the investment environment that we're in. Interest rates have been going up for a year now, and the US Federal Reserve (Fed) has been unwinding its quantitative easing, so this is a completely different investment environment from the one that we've been in for the last decade.

When you have tight monetary policy, this is when financial accidents occur, and Silicon Valley Bank (SVB) and Credit Suisse are not the first of those. We have to remember that last year there was a big scare around UK pension funds, which was thankfully averted, and there was also the collapse of the crypto exchanges. Ultimately, when money is tight, whether that's through higher interest rates or less availability of credit, that's when things become exposed. That's what occurred with SVB, and it reflects the way the US banking system operates.

I think the important thing to take away from this is that people are worried about whether there are going to be further bank collapses and how this will flow through to the economy. While SVB's depositors have been rescued, we can't confidently say that the problems in the US banking sector have been resolved. However, the US is experienced in handling bank failures, they have lots of small bank collapses all the time, and the formula they've rolled out for SVB is a standard approach.

However, even if we do move beyond this, it has made the tight money situation even worse. Regional banks in the US have made lots of investments in 30-year fixed interest securities at 1.5% or 2%, and now their cost of money, which they pay on much shorter time frames, has risen substantially and is much higher than that, so they're losing money on an ongoing basis. When banks are in this situation, whether they survive it or not, and I think they will largely survive it, they will be even more restrictive in their lending. We're already seeing that in the loan surveys from the regional banks in the US. Regional banks are a really important part of business lending; they represent more than half of commercial real estate loans, and they play a large part in small business lending. The outcome of the collapse of SVB reinforces the very difficult environment the economy and markets are in.

* The full interview is available in audio format on The Journal page of our website <https://www.platinum.com.au/Insights-Tools/The-Journal>. Interview was recorded on 29 March 2023.

DM: Do you think central banks will reverse course and start cutting rates from here?

AC: This current banking crisis is predominantly a US phenomenon, and the Fed is in a really difficult position. While there are plenty of signs that inflation is peaking and that the economy is on the cusp of slowing down, it hasn't actually happened yet. The labour market is still strong, wages continue to grow quickly and used car prices, which was a crazy market through COVID where used cars became incredibly expensive, then the prices rolled over, are now rising again. I think that the difficulty here is if the Fed cuts rates in response to the banking crisis but inflation doesn't settle down, all sorts of unexpected consequences can play out, like yields on 30-year or 10-year bonds rising rather than falling. Ultimately, when we are thinking about the investment environment, even if rates do peak at current levels and central banks start to cut, that difficulty in obtaining credit is going to be with us for some time. It takes 12-18 months for rate increases to flow through to the economy, and it's only been a year since the first interest rate increase. We still have all the rate increases over the course of 2022 and the first quarter of this year to really take effect. Yes, central banks may reverse course but I'm not sure that will bring the economy or investors any immediate joy.

DM: Moving to Europe, Credit Suisse aside, perhaps the financial system appears more resilient than what we see in the US and perhaps here in Australia as well, but there is still a war going on, and the energy crisis, while it wasn't as bad as many feared, certainly hasn't been resolved. How are you thinking about Europe?

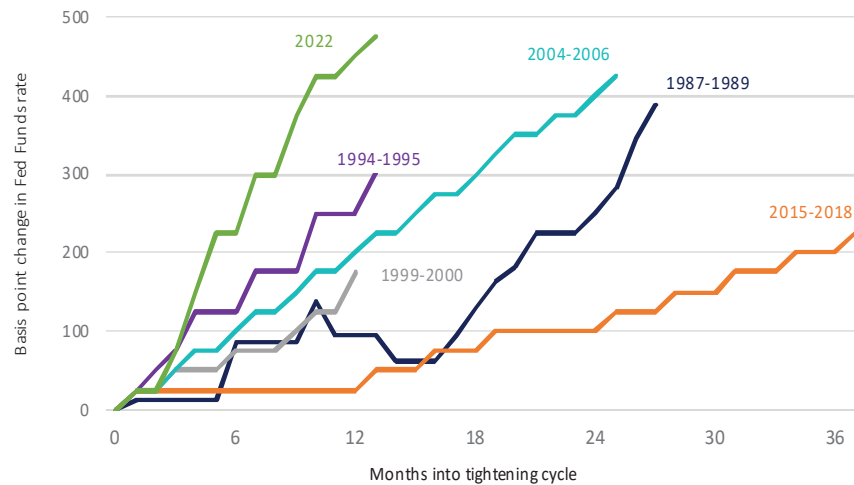
AC: The banking systems in Europe and elsewhere are different to the US, with the latter dominated by fixed 30-year mortgages. By and large, most other countries are dominated by variable-rate mortgages, even if they're fixed for two or three years. This means the banking systems elsewhere, and certainly in Europe, don't take on that interest rate risk. The transmission mechanism will therefore be different because it will be the homeowners with a mortgage and businesses that have borrowed money who will be hurt rather than in the US, where it's the banks that will pay the price for taking that risk. The potentially worrying thing is if there is a significant downturn, where the banks will be hurt elsewhere in the world as borrowers start to struggle to pay off their loans. I think the remarkable thing about Europe is that we've had a war there for over a year now and a huge increase in energy prices at the start of 2022, but yet that economy has remained incredibly robust. There has been no major pickup in unemployment, and economic growth is still positive, even though some industries that rely on gas have had to close down. There was a bit of luck involved, with large parts of the northern

hemisphere experiencing a warmer-than-normal winter and China's economy being very slow, which allowed Europe to source alternative gas much more easily than expected. Europeans have responded to the higher energy prices by cutting consumption. At the moment, gas storage is filling up very quickly, so we're partway through resolving that, but we are also in the hands of the weather. In summary, despite what they experienced with soaring energy prices early in 2022, the economy still managed to perform remarkably well.

DM: With the Chinese economy reopening and the market recovering remarkably at the end of last year, China has been largely out of the spotlight in the first quarter of this year. How are you seeing the Chinese economy and market at the moment?

AC: There were a lot of negatives that lined up against China in recent years. First of all, there were a number of economic reforms that caused significant uncertainty in the business community. Some people will talk about the crackdown on the technology sector, but it was really a regulatory reform of that sector. We also saw policy mistakes in trying to control property prices that led to the property market crashing. There were the COVID lockdowns, and of course, the US was also imposing sanctions and tariffs on the country. So, it's been a very difficult environment, and from there, we only have one way to go. The easiest one to tackle was the end of the lockdowns, and data on people's mobility shows a return to normal levels. Overseas travel hasn't returned to pre-COVID levels, as there are apparently shortages in approving visas, but all of the reopening activities that we've seen elsewhere are starting to happen in China.

Financing has been provided to the property sector to ensure developments get completed, and we have seen a strong rebound in property sales in the larger cities - not back to the levels they were, but a very substantial bounce from the bottom, and there has even been a slight uptick in property prices. That all bodes well for the economy. Some shorter-term observations are that consumer spending is not yet experiencing the same bounce back in ferocity that we saw in other places after they reopened from COVID lockdowns, so it would seem there's still some degree of caution amongst consumers at the moment, but I think that is simply a question of time. Lastly, the government has signalled very clearly that their work on regulatory reform around e-commerce is now complete, so we expect confidence to start to build. After a period of absence, Jack Ma recently returned to China, and symbolically, I think that's a very positive development for the business community. There was also the announcement about Alibaba splitting up its business into six different units.

Fig. 1: US Interest Rate Tightening Cycles

Source: Evercore ISI Research.

DM: So, there has been a lot of improvement in economic fundamentals, but it still feels like the sentiment towards investing in China has not rebounded in the same way, would that be fair?

AC: I think that's right. It's very clear that people are still cautious about China. You can't go from many commentators calling this market uninvestable to a bull market, so undoubtedly, there's a lot of caution, and I think the pattern of coming out of any bear market is that it takes time before the concerns that drove share prices lower are peeled away. I would expect that as we go through the year and we see companies reporting better sales and profits, people will gradually come back to the market, and ultimately, what will bring people back is if China has a good year this year. I have no doubt that those who were calling it uninvestable will, by and large, return and invest in that market.

DM: There are a lot of different economic and geopolitical concerns still at play, can you bring them together in terms of your outlook for major markets?

AC: What's been interesting in the last couple of quarters is the relatively poor performance of the US market; meanwhile, many European markets are not far from their all-time highs, and China has had a very good bounce off the bottom. The question that is debated on the front pages in the US is whether the bear market has finished. While we've had a good bounce from the lows of 2022, I believe it's likely there is more downside to come. This has been the biggest increase in interest rates we have experienced in the last 40-odd years, and it's the fastest increase in interest rates we've seen by a very long way (see Fig. 1). The reason I would be worried about the general level of the US market

is that interest rates have a very clear relationship with corporate earnings, and when we have rate increases like these, corporate earnings will be very weak, and invariably, that leads to a weak US stock market. Whereas I think China is in a completely different cycle, and Europe, again, is in its own cycle. Having said that, I think that for investors to overly focus on the headline levels of markets really misses the point. There are huge divergences within countries and sectors, and there are companies or industries that have already been sold down heavily, and that's where opportunities lie. While I do think there's more to go in this bear market, I continue to see 2023 as a year of opportunity for investors.

DM: Where are you seeing these opportunities?

AC: We focus our search for opportunities in two key areas. One area is in those companies, industries and countries that are out of favour, where investors' cognitive biases tend to lead them to be too focused on recent events. The other set of opportunities is where there's a lot of change going on, whether it's regulatory, technological or in the competitive environment. There are some really big changes going on in the world today, most notably that the global economy needs to undergo a massive investment cycle to decarbonise, and that is presenting a huge array of opportunities. The opportunity set here is much broader than many people think. Electric cars, wind turbines, solar panels and wind farms are often what most people think of, but really, there's a huge number of companies that will benefit, for example, companies that make semiconductors for electric vehicles or solar panels. There will be opportunities in commodities in a range of areas, and again, people think of lithium and copper, but something like pulp, traditionally just used to make paper, is going to be needed

to replace plastics, and there are some really interesting activities that come out of making pulp that present opportunities from decarbonisation.¹

Since COVID, there have been concerns about the reliance on China and the desire for companies to reshore their production or diversify their production bases. That gives rise to opportunities in a lot of different ways, such as relocating those factories to developed markets, which will need high levels of automation on account of the higher labour costs, so companies that provide that sort of equipment stand to benefit. In the developing markets, countries like Thailand and Vietnam are already benefiting from the huge move of production to their shores, creating investment opportunities.

There is also China, which we've already discussed at length; it is still deeply unloved but also fits into this idea of change. China is a leader in so many areas around leading-edge technology. The whole decarbonisation effort will heavily rely on China.

¹ Portfolio manager Jodie Bannan discusses how wood pulp is being used to produce sustainable packaging alternatives to plastic and also lower CO2-emitting biofuels and bioplastics in this short video: <https://www.platinum.com.au/Insights-Tools/The-Journal/Video-Investing-for-Net-Zero>

Finally, the shift in interest rates will have long-term impacts on particular types of businesses or companies that go beyond just the first-order effect. Banks that have strong deposit franchises, for example, should do much better in a higher interest rate environment because previously they were gaining no benefit from their deposit franchises, while insurance companies will get better returns on the investment of their floats (the money they hold onto from the time customers pay their insurance premium until they make an insurance claim). Alternatively, in areas where there is significant competition from start-ups, a lot of venture capital money will be withdrawn, and these start-ups are going to have to become profitable. In the banking sector, lots of neobanks (online banks with no physical branch networks) are falling by the wayside, and e-commerce businesses now need to break even. They're not going to get more money for many ventures. Many will fail, and those who are left standing will potentially have won the land grab and developed very valuable businesses.

In summary, while it's easy to get caught up in the doom and gloom printed in the headlines, there are a lot of opportunities for investors in this market, and that is what we are focusing on.

MSCI Regional Index Net Returns to 31.3.2023 (USD)

REGION	QUARTER	1 YEAR
All Country World	7.3%	-7.4%
Developed Markets	7.7%	-7.0%
Emerging Markets	4.0%	-10.7%
United States	7.6%	-8.9%
Europe	10.4%	1.4%
Germany	14.7%	2.2%
France	14.6%	8.8%
United Kingdom	6.1%	-0.8%
Italy	14.7%	9.1%
Spain	15.7%	11.9%
Japan	6.2%	-5.2%
Asia ex-Japan	4.3%	-8.9%
China	4.7%	-4.7%
Hong Kong	-2.4%	-5.3%
Korea	9.6%	-14.4%
India	-6.4%	-12.2%
Australia	2.8%	-9.2%
Brazil	-3.2%	-18.7%

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 31.3.2023 (USD)

SECTOR	QUARTER	1 YEAR
Information Technology	20.4%	-7.5%
Communication Services	17.2%	-15.5%
Consumer Discretionary	14.2%	-12.1%
Industrials	6.7%	-1.3%
Materials	5.3%	-9.4%
Consumer Staples	3.4%	0.6%
Real Estate	0.5%	-19.8%
Utilities	-0.7%	-6.4%
Financials	-1.5%	-10.8%
Health Care	-1.7%	-4.1%
Energy	-3.1%	6.5%

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.

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