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CIO Perspectives

TRANSCRIPT

2022 Asset Allocation Outlook

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Jacob Hodes (00:01):

All right, everyone. We're going to get started. Thank you very much for joining today's outlook webinar. My name is Jacob Hodes. I'm a partner of Brown Advisory and CIO of Private Investments. Brown Advisory prides itself on taking a collaborative, team-based approach to serving our clients. We believe groups make better decisions than individuals do, and our firm thinks deeply about the importance of being connected with each other, and with you. We have a firm-wide, all-hands morning meeting, four days a week to discuss any important topical issues, ideas, themes that are happening and affecting our world, and that could impact our client portfolios. We strive to learn from each other with the goal of delivering the most effective performance, advice, and service that we can. Today's conversation, we hope, is emblematic of that approach. We've asked several of our firm's leaders from across different teams to share their thoughts on what they're seeing, hearing, and thinking.

Our hope is to provide you with some insight and perspective as to how we're trying to navigate the markets and the volatile times that we're in right now. Without further ado, I'd love to introduce my fellow colleagues: Sid Ahl, our CIO of the Private Client, Endowment, and Foundation business; Kif Hancock, our CIO over our International Business; Ryan Meyerberg, Portfolio Manager of our Global Sustainable Fixed Income Platform; and Erika Pagel, our CIO of Sustainable Investing.

Today is St. Patrick's Day, and I'd like to start with a quick anecdote. Two years ago, our firm like most others was planning to host various happy hours across our offices to celebrate the day. We thought it'd be fun. But also at the same time, COVID-19 was coming into our consciousness. At the time, we decided to cancel that happy hour, or actually to delay the happy hour, hoping that we'd be able to do it a week or two later. Little did we know that only two years now, many of us are feeling comfortable to come back out, to emerge, and attend that type of event.

So that is to say it's been quite a couple of years in our world. When we envisioned this webinar even a couple of months ago, we hoped that the thoughts that we'd be sharing related to how we were emerging from the pandemic, what we were doing to navigate what we hoped would be an emergence of consumers, of people coming out, spending money, traveling, and those sorts of things. But now, we're confronted with many other critical issues. The war and humanitarian crisis in Ukraine, inflation and the response of central banks, which is a very topical issue, and energy security and the prices that many people are paying for gas, just to name a few of those issues.

So we plan to touch on those and several others today. We'd also love for you to participate. Please use the Zoom Q&A function to share any questions, and we'll do our best to cover whatever you might have on your minds. But with that backdrop, let's jump in.

Sid, I'm going to start with you. Could you talk a bit about the global macro environment really over the last couple years, but focusing in on the last few months as we've seen Ukraine and other inflationary issues really emerge.

Sid Ahl (02:33):

Sure, Jacob, happy to. Thanks everybody for joining. This is the third year in a row we've had a pretty big change to the landscape right after publishing our outlook, which hopefully you've all had a chance to flip through. We had COVID, as Jacob was just referencing, and then last year was the kind of meme stock craze with GameStop and AMC, and now Russia and Ukraine. So it certainly keeps us on our toes.

First, I think we're all feeling agitated about the war, the humanitarian toll, and a wide range of outcomes. Sticking to the investment perspective, I would just say we came into this year positioned for higher structural inflation, realizing we had negative real interest rates, and also a changing environment with central banks tightening monetary policy. This has meant for us reducing bond exposure, shortening our duration, adding to areas like real estate and infrastructure that can benefit from this rising inflation, and utilizing more absolute return hedge funds as a replacement for some of that fixed income exposure. Also meant prioritized cash and fixed income around to ride out volatility.

So, the big impact here the last few weeks has been to Russian securities. Stocks are down 50%, the currency's off 40%, they've doubled interest rates to 20%, and their sovereign and corporate bonds are trading in junk territory. I'd just like to underscore, we have very diminimus exposure to Russia directly in our portfolios. It's less than 10 basis points of exposure, and even on a revenue basis, it's less than 1% of revenues for underlying companies. Even our emerging markets allocations are underweight. So this isn't really about direct exposure to Russia. It's about the secondary impacts that Jacob was referencing. So we're focused on inflation. We're focused on supply chain impacts. We're focused on the impacts to the geopolitical world order, and energy. And these are longer-term themes I think that we've been focused on and have been on minds for some time.

And I think it might be surprising to some that what's happened is we've actually seen shifting within stocks, but not as much out of stocks. U.S. stocks, including small cap stocks, are actually positive since Russian troops entered Ukraine. And so the negative year-to-date returns that we've seen thus far have more to do with central banks raising rates and taking away the proverbial punch bowl, than what's going on in Ukraine. It's no surprise commodity stocks and commodities themselves are up. And it's no surprise to us that emerging markets and Europe are suffering the most, but in aggregate, global stocks are actually up a little bit and the U.S. has been performing well.

So I know we're going to talk about a lot of these issues and double click into some of the changes we're making, but I'd just close by saying it's important in times like these to remain humble about risks and the path that markets can take, but we're also trying to really be focused on making decisions based on disconnects between current prices and long-term value. So we're not trying to predict every twist and turn in the markets.

Jacob Hodes (05:47):

Thanks, Sid. Ryan, as kind of head of our global fixed income strategy, you're really kind of frontline across several different markets. Sid talked a little bit about central banks, liquidity. Maybe you could share some thoughts as to what you're seeing?

Ryan Meyerberg (06:00):

Yeah. The first thing I would say is that this is a different type of environment for fixed income than what we've been used to for a long time. And that's a function of the fact that the world has an inflation problem. And central banks across the globe are in sync now, except now it's to tighten rather than to loosen policy. And that's really where we had been since the GFC. But look, think about emerging market central banks. They've been really aggressive in the context of raising rates over the past six months, but now all the major developed central banks and satellite central banks in the developed world are all now moving towards normalizing policy as well. But we note that there are variations in the pace and the amount of tightening that come from central banks, which means to us that there will be opportunities for active managers to add alpha from geographic and asset allocation decisions in rates, in currencies, and in risk assets.

But it's undeniable that predating the invasion of Ukraine, we've seen pressure on risk assets, as central banks, as Sid said, take away the punch bowl. From our perspective, even with that widening in spreads, valuations in corporate credit in the aggregate are still pretty stretched for where we are in the cycle. And alongside that risk-free rates are still incredibly low in the context of where headline inflation sits. So from our perspective it means that risk-free rates are unlikely to provide the same levels of protection in the global slow down or recession that they might have in previous cycles. And it means that investors are going to have to approach navigating this cycle differently than they might have in past cycles.

Jacob Hodes (07:27):

Erika, maybe you could take that from a U.S. perspective, as far as navigating what we're seeing. Maybe we'll start with you; then Kif, turn over to you on the international side. But Erika, why don't you jump in?

Erika Pagel (07:37):

Great, thanks Jacob, and thank you, everyone, for joining today. So headed into this year, we did expect some market volatility. We anticipated a bumpier market than what we've seen particularly in the last year. And the last few months have been some of the most difficult since the start of the pandemic. This is the first correction that we've experienced in two years. We also started the year in January and February with a pullback in growth stocks, as investors anticipated higher interest rates. Fourth quarter earnings season came in better than feared. There were some volatile moves for certain companies. As we look forward, input costs, wages are rising, so we think that in the next couple of quarters and for earning season, the tone might switch from a focus on revenue growth to one that's focused on margin growth.

Sid mentioned this, and Ryan mentioned this, that things are changing quickly. There’s several shocks that are happening at once right now. The invasion of Ukraine has led to performance declines across most all U.S. sectors, with the exception of energy. And there's an impact from a shifting paradigm in the global energy market supply and demand. And that's leading to a rise in oil, gas, and commodity prices. So when we sit here today, demand is much more vulnerable to these rising commodity and oil prices.

Sid brought up a chart that showed kind of various parts of the markets and performance, and we mentioned this in our market outlook. And this still holds true today. We're still seeing a lot of dispersion under the surface for a lot of sectors. Large growth and small growth have been particularly hit this year, but in the backdrop we have seen some improvement in the U.S. economy. So pressures have eased a bit in the U.S. from COVID related disruptions. There's also some small signs of an improvement in labor shortages, particularly in leisure and hospitality. And if we take a look at U.S. within our portfolios for clients, right now we're recommending a good balance between both value and growth within U.S. equities. And we are being patient in making any shifts in portfolios, just given the day-to-day market volatility.

Jacob Hodes (10:00):

Kif, is that consistent on your side when it comes to international?

Kif Hancock (10:04):

Yeah, I definitely think it is. Ryan touched on this, but I think from the view from London, or I should say Europe, we often talk about how we're macro aware, but not macro driven. But one of the interesting things that's sort of come out of the recent situation in Ukraine, I think most people anticipated a hefty response from the United States with respect to sanctions, but the unification of Europe in this entire situation, specifically Germany and a few other countries, I think has been inspiring. It's caught, I think, certain people a little bit by surprise. And really, if you think about it, the European responses has most likely triggered a structural shift in the energy landscape, specifically here in Europe. And, of course, this disruption goes beyond energy into key commodities that are vital to the production of everything from bread to base chemicals. And one of the many lessons that COVID taught us is that global supply chains, they really just take a long time to adapt. So in the near term, we think the main drag on growth here in Europe will likely come from higher prices. But we talk about... Bill Gates, I think, is the one who said at one point that we tend to overestimate the impact or change that'll occur in the next two years with a big event, and underestimate the change that'll occur over next 10. And with that in mind, I think over the longer term, we're questioning whether commodity intensive production capacity, which Europe is full of, gradually shifts out of Europe into closer proximity to those key industrial outputs, maybe in North AmErika. The automotive industry comes to mind. I mean, it's been booming in Central and Eastern Europe for a number of years now. So, it's fluid and it'll take time, but it's something we're quite mindful of.

Jacob Hodes (11:43):

Thanks, Kif. Sid mentioned at the start that as far as direct exposure to Ukraine or to Russia, it might be fairly limited across our portfolios, but I certainly think from a global perspective, it's certainly the topic of the day. So maybe we can focus a little bit more on the war itself, and maybe not just the direct impacts, but derivative impacts as well.

Ryan, I might kick it back to you just to talk a little bit about liquidity, about bond markets in particular. We actually do have a question too, that mentioned about spread widening more in quite a while, and how we think about that too. So maybe you could touch on those topics to start.

Ryan Meyerberg (12:15):

Sure. Look, I think it's undeniable that the war is acting as a catalyst to put more upward pressure on energy, food, other commodities as mentioned. And that's going to create an even more challenging inflationary backdrop than what we had to start the year. And as Kif mentioned and others, it's also likely to cause a meaningful slowdown in European economic growth, which had been growing pretty strongly out of the COVID crisis, and had been expected to grow well above potential this year. But with most material negative market shocks, we watch the plumbing of the market really closely. If you imagine the global economy to be like an engine, it's short-term funding markets that act like the grease or the lubricant that keeps things running smoothly.

And past crises, think about the Lehman crisis, for example, having have been exacerbated by a lack of liquidity in short-term funding markets. So we're keeping a very close eye on certain indicators, like OIS, which is sort of how banks lend to each other, currency swap markets. And we did see at the onset of the Russian invasion that these indicators spiked pretty sharply, but they have all moderated since then. And so it suggests to us that there isn't systemic risk that's bubbling away in the background, but it's something that we need to watch very closely.

And to the question about credit spreads. The war's put risky assets under pressure, especially developed market credit spreads in Europe, emerging market bonds moving lower as the market's starting to price in the risk of a Russian default, which is imminent it seems. And also the risk of a global slowdown, or worst case scenario, potentially a stagflationary environment. Should credit spreads be widening here? We would say that, frankly, after all these years of extraordinary monetary policy and fiscal policy, on a quality adjusted basis credit spreads have been in all time tights. And so they probably should be widening as you expect the global economy to slow down. And typically when the Fed starts raising rates, and other central banks hike, risk assets do well. I think it's unlikely this time around because you can see the linkages between the growth of central bank balance sheets and risk assets, and it's really, really tight that correlation. So it's seems very sensible to us to expect that as the punch bowl goes away, that you should see credit spreads widening. The fall rates are still very, very low, and that's a very good thing. So we're not expecting to see really big pickup and spread winding, but this is a natural move for us, and something that we expected coming into the year.

Jacob Hodes (14:32):

Thanks, Ryan. On the risk asset front, maybe, Kif, that's a good segue to you. Talk a little bit about European equities and maybe even emerging market equities too, and kind of what the effects and impacts have been this year.

Kif Hancock (14:41):

Sure. I think maybe going back and building on the idea that we tend to overestimate the impact in the short term. We're beginning to see a little bit of evidence that indiscriminate selling in European equities has opened up some real compelling opportunities, especially in the tech and in the health care space. A lot of that selling may come from North AmErikan colleagues just wanting to step back and wait until things settle a little bit more. But we partner with a few firms here who specialize in small and midcap European equities, and they do so in industries like health care and tech that really have exposure to the US market and sort of developed Europe. And these are high-quality companies, high returns on invested capital that right now in their opinion are traded at valuations they haven't seen for five, seven years.

So we're quite constructive on the landscape here. You mentioned emerging markets, that's a real tricky one. I know Sid had the chance to speak to one of our flagship managers in Asia earlier today. And they're getting, I think very, very constructive, especially in ASEAN around China. I think sometimes that gets lost in the Asia story perhaps to a certain degree, but it sounds like we're hearing similar stories that select high-quality companies are looking quite attractive for the long-term investor right now.

Jacob Hodes (15:59):

Sid, just because Keif mentioned you, I'll turn it over to you and see if you have any thoughts on the emerging market front, but also talk a little bit about what we're seeing. Your chart mentioned commodities run a little bit. Maybe you could talk about that aspect too.

Sid Ahl (16:09):

Yeah. I think Ryan hit on some of these points, but everybody thinks about the oil and gas impact here, and there's going to be a long-term transition as the US and Europe perhaps turn their back on Russian oil and gas and that could lead to higher prices, but we've also disrupted the largest global exporter of nickel and semiconductor grade neon. And these will have impacts on supply chains for semiconductors and electric vehicles. So we're not just going to see gasoline and utility bill impact here. Ryan mentioned agricultural commodities. Russia and Ukraine are big exporters of wheat and corn. And also, Russia makes something on the order of 20% of exports of potash and are big exporters of ammonia and urea. So the fertilizer market impacts are going to be felt and commodity markets were already tight before this. I mean, there's just a couple of things that we think about. First of all, this could put some margin pressure on companies, but it really impacts, especially food and energy, the lowest earning across the world. The kind of bottom 20% in the US will spend 40, 50% of their disposable income on food and energy. And in emerging markets, it's on average about 40 or 50%. There are positives and negatives here with regard to emerging markets. There's definitely a short-term pressure on the consumer, but there's obviously been a pretty big decline in prices. And so what we're trying to do is be very targeted with the exposure that we have in emerging markets. It's much more focused on Asia and it's a little bit more focused towards some of the really high-quality long-term growth companies that we want exposure to in Asia that obviously will be less impacted given their higher margin structure and pricing power. There are many things to be thinking about. I would say the last thing is with regard to kind of stock by stock in our portfolios, we're thinking about companies that can get squeezed by discretionary spending coming down in certain areas, and then companies that can benefit as consumers kind of trade down to more value brands.

Jacob Hodes (18:41):

Thanks, Sid. Erika, I would like to double-click on energy. You mentioned that in your opening as well. You obviously, as CIO of Sustainable Investing here, think a lot about energy transition, but as well as kind of the current pricing situation. Maybe you could just talk a little bit more about that and what you're thinking.

Erika Pagel (18:56):

Yeah. So the volatility that we've seen in energy prices is not for the faint of heart. So remember that back in 2020, WTI crude actually went negative. Over the past couple of weeks, crude approached $130 and now, today, it's trading anywhere between $100 and $102. So it's been quite a roller coaster ride and how companies as well as consumers navigate that, it's not easy.

The crisis in Ukraine has resulted in several governments revisiting their energy reliance and sources. And so this could result in shifting energy policies and priorities as many countries focus much more on the security of supply. The European Commission came out about a week ago and announced a plan to reduce reliance on Russian gas by two thirds by the end of this year. And they also proposed a plan to make Europe independent of fossil fuels before 2030. It's important to note that a plan does need to comply with the EU Climate Law, which was approved in 2021.

So going forward, there's probably going to be some short-term options that solve for this lower reliance on exports from Russia. There's been a lot talked about LNG, liquid natural gas, as being one of them. There's probably going to be a scramble to replace resources in the short, intermediate term. But I think, if anything, right now, this conflict does underscore the need to escalate, to transition to renewable energy, but it's complicated. Sid just mentioned, it's going to take time. This is a multi-year process. In many ways this is being referred to right now as a watershed moment in the energy industry.

Just lastly, the chart that we brought up earlier, you will notice that a lot of clean energy companies have exhibited very strong performance over the past couple of weeks, and that's coming off of a year of pretty detracted performance. So clearly investors are grabbing attention again towards renewables.

Jacob Hodes (21:05):

One subtext that keeps coming up obviously then is inflation itself, the pricing volatility. And this is something that well before this year rolled around, and the events in Ukraine rolled around, we were very focused on it. I think we had our doubts as to whether or not it truly was transitory, like some folks thought. Maybe we could dive in on the inflationary side a little bit. Obviously it's something that's very present. We've heard some data points on it. Kif, maybe you could talk, first with you, provide any perspective you can, but specifically how we're thinking about navigating the inflationary environment on the investment side.

Kif Hancock (21:37):

Sure. It's probably the most discussed topic with clients not only in the past, I would say, three to four months, but maybe over the past 12 to 18 as we've begun to emerge from COVID. As we think about sort of positioning portfolios to not just withstand inflation, but sort of thrive, if you will, as best one can in an inflationary environment, we've had a strong bias towards economic infrastructure assets and those with explicit inflation protection. And we've had that in place for a few years now. One of the reasons that we like it is the regulated assets in Europe, they operate under a framework for inflation whereby the assets are explicitly linked to the annual changes in the inflation rate. So it comes right through to the revenue line, which is quite a strong hedge. I think we often talk about sort of real assets of gold as inflation hedges. We also like businesses like Visa and MasterCard right now. I mean, we think they're a great inflation hedge, because as higher prices translate into higher revenues, yet the cost structures for these businesses are largely fixed. So they have a lot of operating leverage, which is quite constructive.

But turning back to Europe quite quickly, I mean, one of the questions we get is, with higher inflation, are rates going to follow quite quickly and will that be a bit of a gravitational pull on multiples for some of these infrastructure assets? So I don't really have an opinion there. Maybe it's a good way to throw it over to Ryan to think about what he sees about European rates and inflation.

Jacob Hodes (23:11):

Ryan, you want to jump in?

Ryan Meyerberg (23:13):

Yeah. Well, I think, certainly in the context of central banks and inflation, we had the Fed yesterday and everyone's sort of front and center, and it was a hawkish meeting. And I think it's very indicative of where every central bank finds themselves right now, I think. The FOMC is finally acknowledged that there's an inflation problem at hand and they expect to hike aggressively through the course of this year, 150 basis points and that they continue to hike through next year in order to get to a terminal rate, to start to slow down the economy. But the challenges are the fact that they expect core PCE, their preferred measure, to now be north of 4% as opposed to it was sub 3% in December and growth is slowing down.

So I think from our perspective, where the Fed finds itself is where every major central bank finds itself. And I think we need to see rates moving higher to start to choke off inflation. But the reality, I think for Europe especially is that there are these secondary spillover effects from the war in Ukraine that is causing a lot of consternation with the Bank of England, the ECB in terms of starting to move into recessionary territory. We do think banks will hike rates consistently through the course of this year. We think balance sheet roll-off will be really important as well as a tool to help, to slow down inflation.

But from our perspective, the Fed's really the only central bank that can materially tighten policy given the strength of the US economy. I think Chair Powell yesterday was at pains to reiterate that the FOMC believes that the underlying health of the economy is really strong and they see a really low risk of recession in 2022. And that's a view that we share. But if you look at nominal rates in the US of 2% and where the Fed Funds is, think about Mexico, for example, in emerging markets. Mexico has a lower inflation rate than the US does, but rates are 650 basis points higher. So it's not to say, that was the risk premium that should exist in a country like Mexico. But from our perspective, it means that rates need to be materially higher and not just in the US, but in Europe, whether it's on the continent or in the UK. And that's going to be the trajectory through the course of this year next.

Jacob Hodes (25:18):

Ryan, you're popular in our Q&A function today. I'm going to do a quick follow-up with you. But one of our questioners said that they heard an interview where the comment was made, that the Fed can't raise rates high enough to combat inflation and what the risks may be if the Fed doesn't act quickly enough or what other tools may be available in order to combat that rising rates. Maybe you could dovetail on that. And then Sid, I might turn it over to you to share your thoughts as well.

Ryan Meyerberg (25:40):

Yeah, I think we would say, and I think many would agree, that the Fed has been woefully behind the curve in the context of trying to get in front of inflation and clearly they have acknowledged it now. They are going to start raising rates aggressively. But the risk is, and I think this is where most central banks are going to find themselves is, if you are too slow in hiking rates, you run the risk of having de-anchored inflation expectations. And when inflation expectations become embedded materially higher, it's very hard to get them to come down again. The Japanese have had the opposite situation for decades. When deflation, disinflation became entrenched, there's basically been nothing they can do to get inflation expectations to move higher.

So the Fed is going to need to hike rates aggressively. And in fact, they have said, in their projections with this inflation rate now at 4%, for 2022, they're still concerned that there are upside risks to that inflation. So they have left all the tools on the table. They have basically forecasted and kind of foreshadowed these 25 basis point hikes over the next seven meetings, but there's this option to hike faster, if necessary, 50 basis hikes, if they need to. But I also think they have other tools and that tool is definitely the balance sheet. If you would say that inflation is at a four-decade high and the Fed would still be buying securities, we'd all think you'd be crazy. So that's definitely something they need to do and that they will do in May. They're going to start to roll-off the balance sheet.

So that's another tool that they have, but they also believe that inflation is being caused by some outside factors. Labor market's really tight, we see wage pressure. But they think more people come to the labor market, they think that some of the supply chain issues will work themselves out. We will see if that happens, but the Fed's going to need to be aggressive. And it remains to be seen if they can take a measured approach or it needs to be a Volcker approach. And that's really going to be where rates are going hundreds and hundreds of basis points higher. And if they need to do that, Powell has said they will do that. And that will be a very challenging backdrop for them.

Jacob Hodes (27:34):

Sid, what about you?

Sid Ahl (27:35):

Yeah, it's really interesting because at the end of the year, when we were looking at the inflation situation, we definitely saw the potential for inflation staying much higher, say three, 4% for an extended period of time. And we've often talked about how it's really, when inflation stays above 5% for a material period of time, that that's when both stocks and bonds can suffer and you really need to have much larger allocations to real estate, commodities, infrastructure, et cetera. And so what this has served to be is a bit of a supply shock, a little bit like what we had in the 1970s that has just increased that probability. It doesn't mean it's a certainty by any stretch of the imagination, but it's one of the reasons that we've opened up our minds to even larger allocations to real estate infrastructure and even potentially commodities in portfolios because that probability’s increased. But there are no certainties. There are only kind of probabilities in investing.

I think Ryan's point is really interesting about the behavioral side of this. The longer it lasts, also, the increasing probability that it gets set into the psyche. But we also have to remember, and we wrote about this last year and the year before that there are still some really long-term structurally deflationary forces at play here, demographics, aging economies, not just in the US and Europe, but also in China, slowing population growth, high debt levels, and just a very different economy than we had, say, in the US in the 1970s, when we had a much more highly unionized labor force. And when a bigger portion of what we were spending our money on were goods rather than services.

And then we do have some cyclical elements that should get a little bit better, right? When we were locked up during COVID, we were spending all of our money on goods and nothing on services. There will be a transition as the economy reopens to spending more money on services, and that can balance out some of the really intense inflationary pressure we felt on the goods side. I think the bottom line is the probability has increased and that's what we will react to, but by no means is it a certainty that we're going to be looking at five, six, 7% inflation or interest rates. And the last point I'd make is just that inflation or interest rates. And the last point I'd make is just that we're still in a place from an asset allocation perspective where real interest rates, so interest rates minus inflation are really negative. To Ryan's point, maybe positive in Mexico and positive in Brazil. In the US, they aren't. And that forces us as asset allocators to have less in fixed income and more in some of these yielding real assets. I'm sure we'll talk more about real estate as an example of that. That's one area we've leaned into a lot the last few years.

Jacob Hodes (30:31):

So just a quick follow up in terms of the variables that we look at. When we think about wages and what they're doing, where do we see wages going? Are they inflating? Are they stagnating? And how does that play into the economy?

Sid Ahl (30:42):

They are definitely inflating, and we have a tight job market. And in some parts of it have been a little confusing because we've had a lot of people looking for work and a lot of people looking for employees, and they haven't always been meeting in the middle. It's been kind of a bit of a mismatch. So there is wage pressure, and that's something that's very different from the last 20 years when we've seen the kind of a stagnating wage environment. That's one of the reasons that we were convinced before this that we could have structurally higher rates of inflation. So to Erika's point, I think there are some improvements in that as people are kind of being forced to come back into the labor force as the pandemic seems to be coming to an end, but that's one of the things we've got our eyes on.

Jacob Hodes (31:27):

Well, so maybe, Erika, over to you, can you talk a little bit more of just going back to the inflationary environment that we're in? How do we help clients navigate these things? How do we think about growth versus value as far as portfolio construction? How are we advising our clients to really manage the situation?

Erika Pagel (31:43):

Yeah, thanks, Jacob. I'll just add one area on the wages. And I thought it was a good analogy that I've seen recently. So we all hear about wages going up and how that impacts corporations and margins and potentially just another input cost that corporations have to deal with. But on the earnings side, if you include inflation, you might even say in some areas that earners have actually gotten a pay cut after inflation with the wage increases. So it's something that's very much on our mind. Going back to value and growth, the past year and a half has been a really interesting market. We've essentially seen this tug of war between hyper-growth stocks on one side or reopening stocks on the other side. It's really been this duel between risk-on and risk-off sentiment.

This year, growth companies have been hit the hardest. We've seen multiples really move lower even though they're still elevated for many versus historical norms. And then on the flip side, you have kind of value stocks. These tend to be much more cyclically or economically sensitive. They appear cheaper than growth stocks, but there's still a lot of volatility in the market. So what we're recommending right now is an equal balance between both growth and value within your portfolio. Value companies tend to have a little bit less sensitivity to interest rates. However, we still do like a lot of high-quality growth companies. So a balance of the two in this market environment – an environment where there's potentially a very broad range of outcomes.

Jacob Hodes (33:24):

Thanks, Erika. I want to talk a little bit about where we see opportunity, but just remind folks that please feel free to enter questions in the Q&A chat function. We really appreciate any and all questions that you have. I do want to lean forward in terms of how we're thinking more about navigating it. Erika, maybe we'll stick with you just as far as we think about trying to see what we can do for our clients in this environment. We do have a specific question on electric vehicles and particularly in the EU. What's the EV adoption rate? Where do we see that going? Kif, you might want to touch on that too, but Erika, maybe you could start with you and then we'll kind of keep going from there.

Erika Pagel (33:57):

Yeah, sure. So maybe I'll hit electric vehicles first. In our market outlook, we talked a lot about electric vehicles. I think consumers are very interested in this from an investment standpoint. But if you look at some of the companies that are out there today, there's a lot of orders, not a lot of units being delivered. There's a lot of assumptions being made into current valuations for many companies that might not yet have revenue or profitable or are profitable. But I think this is probably... And Kif mentioned this earlier, an industry to watch. So we've absolutely seen an uptick within the EU for electric vehicles. I saw something that last year registration. So new registrations for vehicles increased three to 4%. And so EV is now roughly kind of low teens as far as 12% of new registrations within the EU.

EV is still a smaller portion in the US. We'd expect that to grow. The last estimates that I saw is kind of mid to high single digits as a portion of total cars within the US. But there's going to be a lot of opportunities. There'll probably be execution risk. You now have most of the auto manufacturers exploring this in some shape or fashion. As far as switching to opportunities, just to take a little bit of a quick step back. When we build portfolios for our clients, we utilize a three-bucket approach. First, we have an operating bucket that squarely focuses on what Ryan has talked about. So liquidity and stability, cash, and short-term fixed income. We have a core bucket, which is marketable securities that pursue long-term goals. And then our opportunistic bucket that can contain idiosyncratic investments, those that might have a window in time.

So positioning for portfolios in this current environment, Sid mentioned, we've leaned more into short duration on the fixed income side. Our largest equity allocation right now is within the US. I mentioned a couple minutes ago that we're very balanced between growth and value, focusing on high quality companies that exhibit strong pricing power and cash flow generation. But we also see a lot of opportunities in real assets right now. So on both the public and the private market side. So looking for opportunities that can play defense, in the event that we do have a stagflationary environment, but also offense so we can think a little bit more in strategic areas. We've talked a lot about energy transition but also security. The other component on the energy transition side, we think that this is a really big opportunity for investors and for innovation in the years to come.

Jacob Hodes (36:47):

Thanks, Erika. Sid, maybe we can kind of go over to you to talk a little bit about where you see opportunity. In particular, one of our questions in the chat function is for balanced portfolios: What can actually replace bonds? So maybe you could talk, start there with bond replacements. And Ryan had been saying that you were getting a lot of love. So someone here is not smitten with the bond market.

Sid Ahl (37:07):

You could never replace bonds. Ryan, don't worry about that. Look, it's hard to replace bonds. One of the things that the bond allocation has that most of the other alternative don't have is liquidity. And so it's really hard to do this without taking some illiquidity risk or taking other kind of equity-like risk. But some of how we've tried to replace the yield and defensiveness is take some of our equity allocation and fixed income allocation and put it in publicly traded, listed infrastructure assets like what Kif discussed. Some of that in certain client portfolios, it could be a fit to be in commodities directly or MLPs or other areas depending on people's preferences. But real estate, I think, is probably the thing we've leaned into most over the last few years.

And what we like are areas like multifamily and industrial real estate that can generate a pretty attractive yield, but it's a yield that's not fixed like it is in the fixed income market. It's a yield that will increase, especially in multifamily has been increasing a lot. As wages rise and inflation rises, rents are rising as well. So kind of 20% plus across the board over the last 12 months, rent increases in a lot of our multifamily portfolios. And so it is potentially a four or five, 6% yield that will grow over time and could see price appreciation.

So also the fundamentals of the US for real estate market are still really strong. We've underbuilt. Ever since the financial crisis, there is a big gap in terms of the homes needed versus what is out there in the market. And so that supply demand dynamic is very supportive, we think, of real estate. The last thing I'd mention is absolute return hedge funds. It's very hard to find them, but there are a few that we have and use actively on our platform. It is less liquid if you are bringing different types of risks on, but that's another way to try to replicate that kind of uncorrelated exposure in a portfolio that's kind of a modest return, not equity-like, but diversifying.

Jacob Hodes (39:28):

Thanks, Sid. Kif, maybe I could ask you actually one of the questions maybe could segue to you is that, is there an increased opportunity in Europe now or should we be pulling back altogether?

Kif Hancock (39:39):

I think in select sectors, there's an increased opportunity. Europe is known, a little bit as sort of a cyclical, industrial base. A lot of the large-cap companies tend to be very energy-intensive. But we don't necessarily associate what we would consider to be cutting edge health care technology in Europe. And that's predominantly because a lot of those businesses are small and mid-cap companies, where in the US they're large mega cap companies. So when we think of software in Europe, it may be a two to $5 billion market cap company; where in the US, something like Microsoft is worth well over a trillion. Same thing in search and other areas, or semiconductors for an example. So in those specific areas, we're really, really constructive on Europe. And next to that, I mean, it sounds a bit... It's not necessarily the most exciting thing, but Sid just alluded to it. And earlier on, you alluded to the fact that we have our morning meeting four days a week. And I guess for the audience, JJ Baylin who heads up our real estate here at Brown was talking about high density multifamily in the South and Southwest, where you just have some great fundamentals backing that up. So for a European investor or a UK investor where rates have been very low for a long period of time to have something that can deliver an eight to 10% return on sort of core high quality class A properties with a nice coupon and steady appreciation that can keep up with inflation in the US dollar is a pretty compelling argument. So I think having that US access through all of our colleagues has been a real differentiator recently.

Jacob Hodes (41:17):

Ryan, any thoughts?

Ryan Meyerberg (41:19):

Yeah. Like I think these are markets, especially from the fixed income side that require you to stay nimble. Active management's key. And we're really focused as Sid and Erika mentioned on the role that we are meant to play as fixed income managers. It's protecting on the downside and delivering negatively correlated returns to equities. But as we mentioned, this inflationary backdrop makes that historical defensive playbook slightly less applicable as risk-free duration that we tend to use like US treasuries, UK gilts, German bunds haven't performed as they typically have. So from our perspective, it's really important to find ways to hedge downside risk in fixed income portfolios. But also, where do we play offense? For us, it's usually the euro and sterling versus being long commodity currencies and the dollar, for example, being long inflation link securities in the US, in Japan, and in the UK.

And also where their opportunities is we don't believe that global recession is likely to happen in 2022. So as I mentioned, spread levels in corporate credit are getting wider. Outright yield levels, and emerging markets are starting to look interesting. We are looking for, just like on the equity side, we're looking for strong cash generated business models that have pricing power. Flexible, insulated, cost structures, recurring non-discretionary revenue that are trading at levels where we feel we're getting paid significantly to own the risk. And actually, we're seeing those opportunities pop up. And so we are definitely leaning into those as they arise.

And we're getting to levels of investment grade credit where historically on an aggregate, you get paid to hold them over the cycle. You're going to make money if you're buying them at 175 to 200 basis points in terms of spread. And also just on the emerging market side, I think this is really interesting. Emerging market countries have improved their current account balances. They've built up really large currency reserves over the past number of years, which make them a lot more resilient to economic slowdowns than they would've been in the past. And so from our perspective, where outright yields are, we think the back half of the year will be really interesting in certain countries to be increasing our allocation to EU more broadly.

Jacob Hodes (43:17):

Maybe, Ryan, I'd love to just follow up with some questions that are coming in through the chat. Maybe talk a little bit about... You've talked about central bank, but maybe Fed bond buying and kind of the monetary easement, quantitative easement policies that have also kind of been part of this and how shifting sense of that could change that. Just talk a little bit about how the bond purchases made by the Fed have maybe kind of played into inflation and how we think that could be filtering through at a more hawkish Fed going forward.

Ryan Meyerberg (43:45):

Yeah. I mean, I think it's undeniable that then as I mentioned, that when you look at almost any risk asset overlaid to the expansion of the Fed's balance sheet in terms of buying mortgage securities, treasuries. After the COVID crisis, say it buying corporate bonds has had an impact in terms of liquidity and certainly has caused risk assets across the board to appreciate. And so, again, the Fed's, one of their policy tools is to shrink that balance sheet. We expect that to happen. We expect it to over time act as a dampening impact or have a dampening effect on inflation. So, you pump more liquidity into the system, and it's more dollars chasing finite assets. And so, clearly, they've had a huge impact along with every other developed central bank. Bank of Japan has been buying assets for years. The ECB as well. I mean, the size of the balance sheet as a percentage of GDP is huge. And so all those central banks are going to start winding down bond purchases. Bank of Japan probably the last one to move. And so we expect that to have a dampening effect on inflation but certainly to have a potential negative impact on risk assets as well.

Jacob Hodes (44:57):

Thanks guys. One other question, one other area, frankly, we haven't talked about yet, and we only have a few minutes left, really, so maybe kind of go quickly through this, although it's very important. It's the shadow of China looms large, obviously, on the global economy. And there're several different things coming out of China right now. There's the fact that 50 million people are in a lockdown. What could happen there from a supply chain perspective? There's the tech stock beating that China's had itself. And some of actually the guidance that China provided just yesterday in terms of what the country may be willing to do in order to support its industries. But would love to have a quick conversation about how investible China is today. Sid, maybe we could start with you.

Sid Ahl (45:35):

Sure. I could take a stab at that. And we do address it in our outlook piece. We do still think China is investible. If we look out 10, 15 years, it is quite possible that China will be the largest economy in the world. It has very deep and liquid capital markets. So there are a lot of investible companies there. And I think we would argue some of the regulations that have come out in the last few years, while they've come out very quickly and very autocratically, the substance of them is not something that we would necessarily disagree with, but it creates a lot of uncertainty. And it requires, if you're going to invest in China, a much higher expected rate of return. I think where we've chosen to focus more of our capital in China is on the domestic markets. I mean, I do think increasingly China is going to force companies not to list abroad and to list domestically. And so we would want to be with local experts that can invest domestically in those markets. And I think Erika may touch on this as well, but there are some pretty critical components of EV supply chain and infrastructure and renewable and solar panel supply chain and infrastructure that are located in China, and thematically are areas that we are positive on. And we are getting some of that exposure from China. Just lastly, the Chinese tech stocks, I don't think anyone would argue that they are very, very cheap relative to the cash flows that they are generating. But it is a very uncertain environment. So we do own some of the most high quality businesses that are now trading as if they are cyclical value businesses when they still have great long term runways for growth. But we're conscious that things can overcorrect even more materially from here.

Jacob Hodes (47:40):

Erika?

Erika Pagel (47:43):

Yeah. Specifically, on the point that Sid mentioned related to ESG. So China's moved to common prosperity, so that's aligning corporate growth with social responsibility. It could over time lead companies to adopt greater ESG transparency and business practices. So think about companies implementing employee benefits, environmental and social impact programs. That could reduce risk over time. But it's important to note that there's still a lot of work to be done here. Policies and many industries are just being constructed. Companies are trying to figure out how to navigate this current regulatory environment. If we look at the companies that have audited ESG reporting, that number is still very, very small. And we've seen some improvement. But again, it's pretty tiny.

On the point that Sid made, China has very ambitious goals for reducing carbon emissions and becoming carbon neutral by 2060. China right now holds the status as one of the top global emitters, so just under 30% according to the IEA. And two thirds of that is coming from coal. So the ability to transition from coal to renewable energy is going to play a big role in meeting these goals. But it's also important to note that the ability of China to follow through on these goals will have great benefit globally in cutting global carbon emissions.

Jacob Hodes (49:25):

Kif, maybe I could just ask one last quick question for you. And then I really do want to end on a quick round the horn on where we see opportunities or main takeaways that the audience today can have. But Kif to you, on your thoughts on supply chains, commodity pricing, you've talked a little bit internally about how there's a lockdown in China, what impact and influence that may have. And as we see that COVID is a persistent factor, that it is not necessarily going away, that and other of the geopolitical situations around the world could in fact, at intermittent times, affect supply chains. Just any thoughts on how we're navigating that or how you think about that?

Kif Hancock (50:01):

I think the problem will ultimately be solved. It just takes time. We all listen to a lot of podcasts, and a statistic thrown out on one Sid and I shared recently was that Amazon, for example, has spent more in CapEx I think over the past two years, or they will do over the next two or three years, than the previous 17 years combined. The capital expenditure of Taiwan Semiconductor, which is really in some ways at the heart of this sort of China-US relations, because we know how reliant we are on that specific company with respect to so many things in the global economy that are linked to semiconductors. I think they're spending something like 44 billion this year on CapEx. So anytime with sort of goods, there's demand. The marketplace seems to be quite efficient at meeting that demand over time. So I don't think we have a lot of worries there. It's just about, I think, patience and observation.

Ryan alluded to it earlier, and I think Sid did as well, on the wage pressure with respect to inflation. Because there's two sides of inflation, obviously. There's the goods side, and then there's just the wage pressure side. I think that one's a little bit more up in the air and that's the one we're kind of keeping a very, very close eye on.

Jacob Hodes (51:15):

Yeah. Kif, maybe I'll just stick with you kind of on the last question. As far as you just mentioned, kind of being patient, taking that long-term perspective, I'd love to hear from each of you any kind of final thoughts or final takeaways for the audience today where you see opportunity, how we're trying to navigate? Really kind of final word for each of you. Kif, why don't we start with you?

Kif Hancock (51:31):

Yeah, I'll just go back to China. I mean, we remain quite constructive on China over the long term. I mean, the Chinese are all are very well known for taking a very long-term view. Sometimes we get stuck on, in the West, thinking about quarters and years, and they're thinking about decades, if not centuries. And so we have a manager who is located in China, they remain quite constructive. However, I will say that they apply a very constructive, if not progressive, ESG lens to all they're investing in China. And that's something that really helps us navigate those waters, because one of the most common questions that we receive these days is: is China investible, from clients here. And we think it is. But it takes, I think, a thoughtful approach.

Jacob Hodes (52:12):

Thanks, Kif. Ryan, how about you?

Ryan Meyerberg (52:15):

Yeah. I mean, just quickly I'd say we are heading into a new market paradigm. Inflation in multi-decades highs, central banks are tightening policy. But the reality is that this is a great market for active management. There are a lot of opportunities that are rising across geographies and across asset classes to add alpha. From our perspective, volatility and dispersion create opportunities. So I think we should be viewing this as a really good thing as investors. It's not something to be afraid of, and we should be leaning into these long-term opportunities that are really popping up on a more regular and frequent basis now.

Jacob Hodes (52:47):

Thanks Ryan. Erika?

Erika Pagel (52:50):

Yeah. The only thing that I would reiterate and add is to really be patient during this market volatility. As Ryan mentioned, there's going to be opportunities to make changes within portfolios. And I think right now, diversification is key. We've talked a lot today, as well as in our market outlook piece, about a wide range of outcomes. I think importantly for those portfolios that are generating income or do have liquidity needs or distributions to supplement that income in the short to intermediate term, and to have a really balanced approach within equities, and consider some alternatives that might align with your long-term goals.

Jacob Hodes (53:36):

We always like alternatives in private equity in the morning meeting crew. Sid, maybe last word to you.

Sid Ahl (53:42):

Sure. I think a lot has already been said. I do think the new paradigm, I think, is interesting. For portfolios that do not have exposure to some of these inflationary beneficiaries, these are things, these are tools that we think we will need more in the next coming years from a longer-term perspective. That being said, I really love Kif's point about quality businesses like Visa and MasterCard where their revenues are going to reset with rising prices. Quality focus here. Great companies will not only be able to pass through price, but will also be potentially gaining share from weaker competitors in a time like this. And so if you keep the quality bar high, that's really important in a time like this.

And then the exciting part is we haven't had much to talk about from an opportunistic investment standpoint for the last few years, and we're starting to have a lot more. I mean, it could be in a year that we have a high yield or a distressed opportunity set. Right now, we see interesting opportunities in the biotech arena, where we have a long-term view of the potential there, and valuations have come way down. And there may be one emerging right now in some really high-quality tech companies that have had their stock prices cut by 50, 75%. So it's a really interesting and exciting, although nerve-wracking, time. But this is, to Ryan's point, I think when active management, when you're purchasing some of these securities with a long-term view, can shine for the next five years.

Jacob Hodes (55:17):

All right. Well that's, I think, a good place to end it. But thank you to all the panelists, and thank you to everyone who participated today who dialed in. We certainly appreciate the opportunity to serve you, to share our thoughts. Just want to reiterate that we do think that the next year is going to be very tough to negotiate. There is a lot of unknowns. And frankly, one of the most valuable aspects for us is hearing and seeing the Q&As that came through, what's on your mind, what you're thinking about. So please know that we are going to work very hard every day to serve you, to make sure that we are trying our best to help you navigate the situation. I'm sorry that we didn't get to answer some of our Q&A questions. But again, this team and the rest of our firm is always here to serve you. We thank you for dialing in.

Jacob Hodes (55:54):

The recording of this will be available in the next week. So please feel free if you feel the need to listen again to anything we said, or to share with your friends. We certainly welcome that. We hope to hear from you soon. Take care. Stay well. And thanks for joining us today.